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### Significant 1986 Regulatory and Legislative Developments

David A. Lipton

*The Catholic University of America, Columbus School of Law*

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# Significant 1986 Regulatory and Legislative Developments

*By the Subcommittee on Annual Review\**

## **SEC PROXY REVIEW**

With the adoption of amendments proposed in 1985,<sup>1</sup> the Securities and Exchange Commission has almost completed the proxy review program that it began in 1982. Proposals for revised proxy contest regulations had been anticipated in 1986 but had not been released as of the end of the year. In addition to updating the proxy rules to conform with new laws, current practice, and Staff interpretations, the amendments: (i) apply integrated disclosure principles to proxy statement disclosure; (ii) simplify compensation plan disclosure; and (iii) require new registrants to disclose prior changes in and related disagreements with accountants. The amendments became effective January 20, 1987 for proxy statements filed on or after that date.

## **INTEGRATED DISCLOSURE**

Under the old proxy rules,<sup>2</sup> a registrant could only incorporate by reference financial statements that were included in its annual report to security holders. Revised schedule 14A, adopted pursuant to the Exchange Act, allows a company to incorporate by reference other reported information in substantially the same manner as a company registering securities under the Securities Act. Items 13 and 14 of revised schedule 14A permit incorporation by reference. The manner in which a registrant may incorporate by reference depends upon whether it would be eligible to file a registration statement on form S-1, S-2, or S-3 to register securities under the Securities Act.<sup>3</sup>

\*Franklin E. Gill, vice-chairman; contributors: Mary Alice Busby, F. Daniel Corkery, Jeffrey M. Elliott, David A. Lipton, Michael G. Marks, Brian S. North, Gary Olson, and Ted C. Weitz.

1. Securities Act Release No. 6676, Exchange Act Release No. 23,789, Fed. Sec. L. Rep. (CCH) No. 1203 (Extra ed. Nov. 14, 1986). These rules were proposed in Securities Act Release No. 6592, Exchange Act Release No. 22,195, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985).

2. See 17 C.F.R. § 240.14a-1 to 14c-101 for the proxy and information statement rules, including schedule 14A at § 240.14a-101.

3. Forms S-1, S-2, and S-3 reflect a "tiered" approach, establishing different requirements for the presentation of company-oriented information in a prospectus. The eligibility standards for the use of the forms generally reflect the extent to which Exchange Act reports of a registrant have been

In addition to financial statements, the proxy statement may now incorporate by reference the items the Commission considers to be the basic information package fundamental to all investment decisions. Such "company-specific" information includes: a business description of the registrant; the market price, dividend, and related matters concerning the security affected by the corporate action being voted on; and management's discussion and analysis of financial condition, results of operations, and selected financial data. "Transaction-related" information is information concerning the business combination being voted on and must be presented in the proxy statement pursuant to item 14 of schedule 14A. The distinction between company-specific and transaction-related information has grown out of concepts developed with the integrated disclosure system.<sup>4</sup>

New item 13 of schedule 14A specifies the financial and other company-specific disclosure required for proxy statements covering the authorization, issuance, modification, or exchange of securities. It permits incorporation by reference from either previously filed documents or the annual report to security holders.<sup>5</sup> Registrants need only incorporate by reference the specific sections of a document that provide the required information. In addition, a registrant that incorporates item 13 information by reference to a form 10-K need not incorporate subsequently filed reports.

Registrants qualified to use form S-1 or S-2 may incorporate by reference any of the information required by item 13 if the information is contained in an annual report to security holders or a previously filed document and such report or document is delivered to security holders with the proxy statement. An S-3 registrant may incorporate by reference to previously filed documents any of the item 13 information without delivering the documents to security holders.<sup>6</sup>

New item 14 specifies the information about the transaction, financial statements, and business of the company(ies) that must be provided for mergers, consolidations, acquisitions, and similar transactions. An S-3 or S-2 registrant

disseminated to, and absorbed by, the market. Form S-1 is the form that must be used by registrants that have been in the Exchange Act reporting system for less than three years or for which no other form is available. These registrants must present all company-oriented information in the prospectus. Widely followed companies meeting the requirements of form S-3 need only provide transaction-oriented information in a prospectus and may generally incorporate by reference most company-oriented information. Less widely followed companies that meet the eligibility requirements of form S-2, but not form S-3, may incorporate certain company-oriented information only if an annual report to security holders is delivered with the prospectus.

4. See Securities Act Release No. 6383, Exchange Act Release No. 18,524, [Accounting Series Releases 1937-1982] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982), which adopted the SEC Integrated Disclosure System. Recently, in proposing rule 430A, the SEC used terminology distinguishing transaction-specific information from "substantive" information for purposes of filing prospectuses under SEC rule 424. See *infra* notes 17-18 and accompanying text.

5. In all cases, information may be incorporated by reference under item 13 only if (i) it is not required to be included in the proxy statement by another item, (ii) it substantially meets the requirements of item 13, and (iii) note D is complied with.

6. However, if the solicitation relates to an election of directors, rule 14a-3 applies and an S-3 registrant must deliver the annual report to security holders.

electing to incorporate any of the company-specific information by reference must incorporate the entire annual report on form 10-K and any subsequent reports filed since the end of the fiscal year covered by the form 10-K. An S-1 registrant may only incorporate information from an annual report delivered to security holders pursuant to rule 14a-3 for the meeting to which the proxy statement relates.

When any document is incorporated by reference, the proxy statement must be sent to security holders no later than twenty business days before the meeting of security holders or, if no meeting is being held, twenty business days prior to the earlier of (i) the vote, consent, or authorization of security holders, (ii) the date the transaction is consummated, or (iii) the date on which votes, consents, or authorizations may be used to effect the corporate action.

Just as required by form S-4, new note D of schedule 14A requires a statement on the last page(s) of the proxy statement listing all the documents or portions thereof that are incorporated by reference. Listing all of the documents in one place, rather than throughout the document as had been proposed, should facilitate security holders' requests for information.

### *COMPENSATION PLAN DISCLOSURE*

The amendments simplify the disclosures regarding compensation plans being voted on by combining former items 9, 10, and 11<sup>7</sup> into a single item 10. In addition, the amendments eliminate disparities in disclosure requirements among various plans. For example, registrants were required to provide more detailed information for options described under former item 11 than for options described under former item 9. Information required for options covered by former item 11 but not required for options covered by former item 9 included: (i) the title and amount of securities called for or to be called for by such options; (ii) the prices, expiration dates, and other material conditions upon which the options could be exercised; (iii) the consideration received or to be received for the granting or extension of the options; (iv) the market price of the securities called for or to be called for by the options; and (v) the federal income tax consequences of the issuance and exercise of the options. Item 10 now requires the same disclosure for all options submitted for security holder action.

Revised item 10 is divided into two parts. The first part sets forth the general information that must be provided for all plans being voted on. The second part requires specific information about the type of plan that security holders are asked to consider.

Information is now required only for plans in effect within the last three years rather than the last five years. This information must be aggregated for the three-year period. To prevent duplication, single-year information pursuant to item 8 (compensation of directors and executive officers) need not be presented when aggregate compensation is presented pursuant to item 10.

7. These items respectively related to bonus, profit sharing, and other compensation plans; pension and retirement plans; and options, warrants, or rights.

Furthermore, this three-year aggregate compensation disclosure presented under item 10 will satisfy item 11 of form 10-K (executive compensation for the most recent fiscal year) when item 11 is incorporated by reference to registrant's proxy statement.<sup>8</sup>

Revised item 10 deleted the requirements to disclose information about the sale of securities during a period when purchases were made through the exercise of options. The Staff determined that this disclosure was not useful to a voting decision by shareholders concerning compensation plans and was unduly burdensome.

Certain clarifying amendments were made throughout item 10. Disclosures concerning directors who are not executive officers and disclosures concerning all employees are to be made on a group, rather than individual, basis. Furthermore, disclosures regarding executive officers are required only for those executives in office when the proxy statement is distributed.

### CHANGE IN ACCOUNTANTS

The SEC has revised and extended the required disclosure about a change in accountants and disagreements with them in both schedule 14A and item 304 of regulation S-K.<sup>9</sup> The apparent purpose is to discourage opinion shopping, which also is the goal of guidelines recently issued by the Financial Accounting Standards Board.<sup>10</sup>

Revised item 9 (former item 8) requires disclosure of disagreements in connection with a change in accountants since the last proxy statement if the solicitation involves an election of directors or the election, approval, or ratification of accountants. This disclosure is required notwithstanding prior disclosure of the information on form 8-K. Revised item 304 requires disclosure of this information unless the information has been disclosed previously on form 8-K.<sup>11</sup>

Schedule 14A and item 304 formerly required disclosure only if the information had been reported on form 8-K. Thus, registrants involved in an initial public offering or those not subject to the Exchange Act reporting requirements at the time of the accounting change were not required to disclose this information. The amendments close these reporting gaps. If the registrant has not previously been subject to regulation 14A, the registrant must describe disagreements within twelve months prior to, and any period subsequent to, the end of its most recent fiscal year.

8. Securities Act Release No. 6676, *supra* note 1, at 32.

9. 17 C.F.R. § 229.304 (1986). Item 304(a) is a new paragraph. The previous provisions of item 304 have been designated 304(b). Item 304(b) requires disclosure of the nature and effect of a disagreement with the former accountant and the effect on the financial statement of accounting for a material transaction in a manner different from that preferred by the former accountant.

10. See *infra* note 168 and accompanying text.

11. To clarify any ambiguity with item 9, an instruction to item 304 provides that when required by item 9, this disclosure is necessary notwithstanding prior disclosure.

## OTHER AMENDMENTS

Other amendments clarify the proxy rules and codify Staff interpretations and practice consistent with new laws and other rules under the Securities Act and the Exchange Act.

Revisions throughout the rules clarify that regulation 14A applies to consents or authorizations with respect to registered securities as well as the solicitation of proxies for a meeting of security holders.

Several changes were made to rule 14a-1 (definitions). A technical amendment clarifies that the definitions of this rule are intended to apply to regulation 14A in its entirety. To make the definitions in regulation 14A consistent with regulation S-K, some terms have been redesignated. "Issuer" has been redesignated "registrant." The term "officer" has been redesignated "executive officer," where applicable, and "security holder" has been substituted for "shareholder." The definition of "record date" is new and refers to the date set in accordance with state law.

A new note to rule 14a-6 specifies that, unless revised material contains a "fundamental change," the filing of revised preliminary proxy materials does not recommence the ten-day period before definitive proxy solicitation materials can be sent to security holders. The new note indicates in a somewhat circular fashion that the registrant is faced with a fundamental change when there are "material revisions or material new proposal(s) that constitute a fundamental change in the proxy material."<sup>12</sup>

If material changes are made in the proxy solicitation materials or if material subsequent events occur, an additional proxy card along with revised or additional solicitation materials should be furnished to security holders. A sufficient period of time must be allowed for adequate dissemination of the materials to permit security holders to obtain the information and change their vote(s) if desired.

An S-3 registrant incorporating by reference subsequently filed documents may provide information concerning material subsequent events, such as an acquisition or disposition of assets, through such forward incorporation. Material changes to the solicitation materials, such as a material change in the terms of a compensation plan being voted on, require revised or additional solicitation materials. Even if an S-3 registrant provides information about subsequent events through forward incorporation, the registrant must nevertheless furnish security holders with an additional proxy card, accompanied by a brief identification of the material subsequent event. Moreover, the information must be provided a sufficient time before the meeting or the date consents or authorizations can be used in order to afford security holders an opportunity to obtain and consider the documents containing the information incorporated by reference.

12. Securities Act Release No. 6676, *supra* note 1, at 68. The standard of fundamental change was also used in item 512(a) of regulation S-K for determining when a post-effective amendment is required for securities registered under rule 415. The term is not defined.

## *PROPOSED RULEMAKING FOR BUSINESS COMBINATIONS AND OTHER MATTERS*

The SEC has proposed amendments to conform the proxy disclosure rules for mergers, consolidations, and acquisitions to the disclosure required in form S-4 registration statements for business combinations.<sup>13</sup>

Since transactions subject to item 14 of schedule 14A and business combinations registered on form S-4 require substantially similar decisions by security holders, the Commission has proposed that the company-specific information required for item 14 parallel the information required on form S-4. The proposed amendments require a registrant that provides item 14 information in the proxy statement (rather than incorporation by reference) to include all the company-specific information required in a form S-4 registration statement. These amendments would have no effect on S-2 and S-3 level companies that choose to incorporate this information by reference to form 10-K. The changes would require each level company to disclose the same type of information.

The Commission has proposed a new rule, rule 14a-14, to govern the treatment of modified or superseded statements in documents incorporated by reference into the proxy statement. Rule 14a-14 provides that a statement in a document incorporated by reference is deemed modified or superseded by a statement in the proxy statement or in any other subsequently filed document that is also incorporated by reference. The proposed rule also provides that the modifying or superseding statement is not an admission that the first statement is false or misleading. In addition, the original statement is not deemed to constitute a part of the proxy statement.<sup>14</sup>

The Commission has proposed further revisions to clarify the timing of proxy statement or prospectus mailings when documents are incorporated by reference. Proposed revisions to schedule 14A and form S-4 would clarify that, if no meeting is held, these materials must be sent at least twenty business days prior to the date the votes, consents, or authorizations may be used to effect the corporate action.

## *SHAREHOLDER COMMUNICATIONS ACT: REGULATION OF FINANCIAL INSTITUTIONS*

On November 25, 1986, the SEC adopted rule 14b-2,<sup>15</sup> regulating proxy processing activities of banks and other financial institutions pursuant to authority granted under the Shareholder Communications Act of 1985.<sup>16</sup> The SEC deferred the effective date of the new rules until July 1, 1987 to give banks time

13. Securities Act Release No. 6675, Exchange Act Release No. 23,788, Fed. Sec. L. Rep. (CCH) No. 1203 (Extra ed. Nov. 14, 1986).

14. Proposed rule 14a-14 parallels rule 412 of regulation C under the Securities Act.

15. Exchange Act Release No. 23,847, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,046 (Nov. 25, 1986).

16. Pub. L. No. 99-222, § 2, 99 Stat. 1737 (1985) (amending 15 U.S.C. § 78n & note (Supp. III 1985)).

to adjust their systems. However, the rule requiring banks to furnish shareholder lists at the request of registrants within seven days was effective on December 28, 1986.

The new proxy dissemination rules parallel the rules adopted in 1983 for broker-dealers (rule 14b-1). Registrants are required to send search cards asking each bank to identify the amount of proxy materials and annual reports necessary for beneficial owners. The bank must respond within seven days. Registrants must then supply the banks with a sufficient amount of materials to be forwarded to the beneficial shareholders within five days after receipt by the bank. This system is called the "omnibus proxy approach."

Banks may seek a waiver of the omnibus proxy approach if they act by December 28, 1987. To obtain the waiver, a bank must demonstrate that the objective of the approach can be met by using an alternative procedure proposed by the bank.

For accounts opened after December 28, 1986, banks must provide registrants with the names of beneficial owners unless the beneficial owners object to disclosure. On accounts opened on or before December 28, 1986, banks are not required to disclose the names of beneficial owners unless the beneficial owner consents to disclosure. Therefore, it will be necessary for banks to solicit the consent of beneficial owners to determine whether disclosure is appropriate. If banks fail to make a good faith effort to obtain consent, they must supply the beneficial owner's name to the registrant unless the beneficial owner objects.

## ***REGISTRATION UNDER THE SECURITIES ACT***

### ***SIMPLIFICATION OF FILING***

In October 1986, the SEC issued a release requesting comments on the elimination of pricing amendments and revisions of prospectus filing procedures.<sup>17</sup> New rule 430A under the Securities Act and related amendments would eliminate the filing of many pricing amendments by allowing registration statements to be declared effective without disclosing the price, certain price-related information, and information concerning the underwriting syndicate. Currently this information is required to be filed in a pre-effective pricing amendment to a registration statement. Under the new rule, this information would be either included in a final prospectus and incorporated by reference into the registration statement or included in a post-effective amendment to the registration statement. As a result, information omitted from a registration statement by virtue of rule 430A would be subject to section 11 liability under the Securities Act.<sup>18</sup> To take advantage of the new procedure, a registrant would have to file all required exhibits and any other information required by the SEC

17. Securities Act Release No. 6672, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,038 (Oct. 27, 1986).

18. An additional undertaking (j) would be added to item 512 of regulation S-K providing that, for purposes of determining liability under the Securities Act, information omitted from the prospectus as filed in the pre-effective registration statement and contained in the prospectus filed



in a pre-effective amendment. As stated in its release, the proposal should have the effect of minimizing possible disruptions of a registrant's marketing schedule caused by the need to file a pricing amendment that is declared effective by the Staff.

The new rule would be available to any registrant (including nonreporting companies) offering securities for cash. The rule would not be available for business combinations and in those situations where the filing does not include a delaying amendment and, therefore, becomes effective by lapse of time pursuant to section 8(a) of the Securities Act.

A dividend of proposed rule 430A would be elimination of the troublesome concept of a "convenience shelf" under rule 415. Registrants desiring to avoid the inconvenience of filing a pricing amendment had on occasion filed a registration of securities under rule 415, which is for delayed offerings of securities "on the shelf." The Staff objected to using rule 415 if the securities were really to be offered promptly after filing. Since filings under proposed rule 430A would be declared effective without a pricing amendment, there would no longer be any reason to file under rule 415 just for convenience.

The SEC also proposed a number of amendments to rules 424 and 497<sup>19</sup> designed to ease prospectus filing requirements. Under the current rule, it is necessary to file with the SEC the exact form of every prospectus furnished to investors. Accordingly, a registrant is required to file a prospectus that merely makes typographical, grammatical, format, or clarifying changes. The amended rule would require a filing only if the revised prospectus contains substantive modifications or additions.

To facilitate access to and use of the information contained in revised prospectuses, the SEC has proposed a new classification scheme. A distinction would be made between prospectuses containing transaction-specific information, i.e., information relating primarily to the securities offering such as pricing data, and prospectuses containing other substantive changes or additions. A registrant would be required to indicate the appropriate classification on a revised prospectus at the time of filing.

Shorter filing periods are proposed for prospectuses used after the effective date. A prospectus containing transaction-specific information would be required to be *physically* filed on or before the date it is first used. Mailing such a prospectus to the SEC prior to use would no longer be sufficient. A prospectus containing substantive changes or additions would be required to be filed within two business days (rather than the former five days) after first use or transmitted to the SEC by a means calculated to result in filing by the date of first use (e.g., express mail).

The amended rule would also permit prospectus supplements and "stickers" to be filed with the SEC without the necessity of refiling the related prospectus.

pursuant to rule 424 or rule 497 shall be deemed to be incorporated by reference at the time the registration statement was declared effective.

19. 17 C.F.R. §§ 230.424, 230.497 (1986).

The prospectus supplement distributed to investors, however, would still be required to be attached to the related prospectus.

### *RULE 151: SAFE HARBOR FOR INSURANCE COMPANY ANNUITY CONTRACTS*

The Commission has adopted rule 151<sup>20</sup> under the Securities Act to provide a "safe harbor" for certain types of annuity contracts that will not be deemed to be subject to the federal securities laws.

Section 3(a)(8) of the Securities Act specifically exempts from the provisions of the Securities Act the following class of securities:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

Rule 151 replaces Securities Act Release No. 6051,<sup>21</sup> issued by the Commission in 1979, which adopted a more subjective approach with substantial emphasis on marketing methods. In adopting rule 151, the Commission believes that it is more appropriate to prescribe an objective test for determining whether certain types of annuity contracts fall within the exemption provided by section 3(a)(8) of the Securities Act. By calling the rule a safe harbor, the Commission refrained from setting forth an all-inclusive definition, which would encompass every annuity contract that falls within section 3(a)(8). Instead, the Commission defined a class of annuities that it believed are clearly entitled to the exemption of section 3(a)(8). The Commission asserted that an insurer that claims the protection of rule 151 has the burden of establishing compliance with all its provisions. Furthermore, the Commission stated that a contract that satisfies rule 151 would be excluded from all provisions of the Securities Act, including the antifraud provisions.

Rule 151 sets forth a three-prong test for determining whether an insurer may sell a contract with reasonable assurance that it falls within the meaning of the phrase "annuity contract" or "optional annuity contract" as used in section 3(a)(8). The annuity or optional annuity contract: (i) must be issued by a corporation (the "insurer") subject to the supervision of the state insurance commissioner, bank commissioner, or any agency or officer performing like functions; (ii) must include certain guarantees of principal and interest so that the insurer will be deemed to have assumed the investment risk under the contract; and (iii) must not be marketed primarily as an investment.

Rule 151 also sets forth three conditions that a contract must meet to enable the insurer to establish that it has assumed sufficient investment risk: (i) The

20. Securities Act Release No. 6645, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,004 (May 29, 1986).

21. 1 Fed. Sec. L. Rep. (CCH) ¶ 2111 (Apr. 5, 1979).

value of the contract must not vary according to the investment experience of a separate account; (ii) for the life of the contract, the insurer must (a) guarantee the principal amount of purchase payments and interest credited thereto, less any deduction for sales, administrative, or other expenses or charges, and (b) credit a specified rate of interest to net purchase payments and interest credited thereto; and (iii) the insurer must guarantee that it will not modify the rate of any discretionary excess interest more frequently than once per year.

Because of the requirements set forth in clause (ii)(a) and (b) above, the safe harbor under rule 151 could not be relied upon for a contract with a market value adjustment feature. However, the Commission emphasized that a contract with this feature "should not create a negative inference that no such contract is eligible for the exclusion under section 3(a)(8)."<sup>22</sup>

In adopting rule 151, the Commission underscored its belief that "the manner in which a contract is *primarily* marketed is a significant factor which must be considered in determining a contract's status under the federal securities laws."<sup>23</sup> The Commission stated that "a marketing approach that fairly and accurately describes both the insurance and investment features of a particular contract, and that emphasizes the product's usefulness as a long-term insurance device for retirement or income security purposes, would undoubtedly 'pass' the rule's marketing test."<sup>24</sup> However, the Commission noted that if a "contract is promoted with *primary* emphasis on current discretionary excess interest, and the possibility of future interest or other investment-oriented features of the contract, [then] the contract would likely fail the marketing test."<sup>25</sup> The Commission determined not to publish specific guidelines for sales literature and marketing activities of insurers.

## RELIEF FOR SMALL ISSUERS

### REVISIONS TO REGULATION D AND FORM D

Effective November 10, 1986, the Commission announced revisions to form D and regulation D, which govern the limited offer and sale of securities without registration under the Securities Act.<sup>26</sup> These revisions create a uniform notification form for smaller, exempt offerings that can be filed both with the Commission and with the states. The revisions are part of the continuing effort by the Commission to reduce costs for small issuers and to promote uniformity between federal and state securities regulations.

22. *Id.* at 88,132.

23. *Id.* at 88,137.

24. *Id.*

25. *Id.* at n.47.

26. Securities Act Release No. 6663, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,032 (Oct. 2, 1986). Form D is the notification form that must be filed by the issuer relying on the exemptions from registration provided by regulation D and § 4(6) of the Securities Act. Of course, if a transaction qualifies as one "not involving any public offering" within the meaning of § 4(2) of the Securities Act, counsel may choose to rely upon the § 4(2) exemption from registration without notice.

Because they simplify the form and regulations, the revisions should benefit the states that have adopted the Uniform Limited Offering Exemption ("ULOE").<sup>27</sup> These revisions also are designed to encourage more states to adopt the ULOE. As amended, form D provides instructions for federal and state filings and includes a separate appendix keyed to specific items of the form on a state by state basis. There is also a separate federal and state signature page. An issuer need simply fill in a single form D, then file copies with the Commission and the states.<sup>28</sup> Form D no longer requires disclosure of the issuer's gross revenues, total assets, and number of shareholders. Information concerning the use of proceeds and costs of the offering are now parallel to those requirements in form SR<sup>29</sup> and item 504 of regulation S-K.<sup>30</sup> Form D now only requires identification of an issuer's executive officers, directors, general partners, promoters, and persons beneficially owning ten percent or more of a class of equity securities, rather than all affiliates.<sup>31</sup> Some changes have been made to the layout and organization of form D that are not substantive but intended to make the form clearer and easier to fill out.

The revisions to form D and rule 503 of regulation D eliminate the requirements to file periodically every six months and to file a final notification within thirty days of the final sale or completion of the offering. The initial notice is still required to be filed with the Commission within fifteen days of the first sale of securities in an offering under regulation D or section 4(6).<sup>32</sup>

These revisions simplify the filing of a form D, promote uniformity between federal and state securities laws, and should result in cost savings to the Commission and issuers.

### *RULE 12g: INCREASED ASSET THRESHOLD FOR EXCHANGE ACT REPORTING*

Effective August 15, 1986, the SEC increased the threshold from \$3 million to \$5 million for registration and reporting of issuers under section 12(g) of the

27. See Selected Statutes, Rules and Forms Under the Federal Securities Laws 131 (R. Jennings & H. Marsh eds. 1986).

28. Appropriate modifications must be made by the ULOE to reflect the revisions to form D and regulation D and obtain the uniformity sought by the Commission.

29. 17 C.F.R. § 239.61 (1986). Form SR is filed in accordance with rule 463, 17 C.F.R. § 230.463 (1986), "within 10 days after the end of the first three-month period following the effective date of the first registration statement filed under the [Securities] Act by an issuer, and within 10 days after the end of each six-month period" thereafter prior to a final report.

30. 17 C.F.R. § 229.504 (1986). Item 504 describes information that must be included in a registration statement and prospectus concerning the use of proceeds of a securities offering.

31. Securities Act Release No. 6663, *supra* note 26.

32. Section 4(6) provides an exemption from registration for transactions involving offers or sales of securities solely to one or more accredited investors if the aggregate offering price does not exceed \$5 million and there is no advertising or public solicitation.

Exchange Act.<sup>33</sup> Section 12(g) provides that issuers of over-the-counter securities, i.e., securities that are not already listed and registered on a national securities exchange, must register these securities with the SEC if the issuer has 500 or more record holders of a class of equity securities and total assets exceeding \$1 million.<sup>34</sup> However, as a result of the amendments to SEC rule 12g-1, an issuer is now required to register under section 12(g) of the Exchange Act only after it has 500 or more record holders of a class of equity securities and total assets of \$5 million or more.

The SEC was given authority under section 12(h) of the Exchange Act to exempt classes of issuers from the registration requirements of section 12(g) as long as "such action is not inconsistent with the public interest or the protection of investors."<sup>35</sup> It should be noted that these amendments do not change the registration requirements for companies listed on a national securities exchange to register securities on the exchange pursuant to section 12(b).<sup>36</sup>

These amendments are part of the SEC's continuing effort to reduce the number of reporting issuers to the greatest extent possible consistent with the protection of investors.<sup>37</sup> They were published for comment on October 2, 1985.<sup>38</sup> In response, the Commission received six comment letters, five of which supported the amendments and offered additional suggestions.<sup>39</sup> One commentator, however, viewed the increased asset threshold as harmful to investors due to the inability of the market to value the securities of current issuers that would

33. Exchange Act Release No. 23,406, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,012 (July 8, 1986) (amending SEC rules 12g-1, 12g-4, 12h-3 and form 15 (certification of termination or notice of suspension of filing)) [hereinafter Asset Threshold Release].

34. Congress set this \$1 million asset threshold based on 1964 economic conditions. See Exchange Act Release No. 23,407 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,013 (July 8, 1986). In 1982, the SEC implemented an exemption system using rule 12g to raise this threshold to \$3 million to reflect increased compliance costs. *Id.*

35. 15 U.S.C. § 78l(h) (1985).

36. See *id.* § 78l(a)-(b). Subsection 12(a) provides:

It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this chapter and the rules and regulations thereunder.

Subsection 12(b) provides, in relevant part, that a "security may be registered on a national securities exchange by the issuer filing an application with the exchange" containing the information and documents enumerated in § 12(b)(1)-(3).

37. The Commission's efforts are consistent with those required by the Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477 (Oct. 21, 1980), "to remove unnecessary and burdensome regulatory restraints on the capital raising efforts of the small business community" while retaining investor protection. Asset Threshold Release, *supra* note 33, at 88,174 n.4.

38. Exchange Act Release No. 22,483 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,920 (Oct. 2, 1985).

39. See Asset Threshold Release, *supra* note 33. The SEC incorporated these suggestions into its Advance Notice of Proposed Rulemaking, Exchange Act Release No. 23,407, *supra* note 34 (seeking appropriate threshold criteria to determine which companies must enter Exchange Act reporting system). For a discussion of this release and the comment it has generated thus far, see *infra* notes 42-45 and accompanying text.

become exempt from the Exchange Act's section 12(g) reporting requirements. The SEC disagreed with this commentator and stated that of the approximately 700 companies that could become exempt under the new asset threshold, approximately 270 would continue to voluntarily report to maintain their NASDAQ listings. The SEC further reasoned that other companies, whose securities are traded in the ordinary over-the-counter market, would still have to publicly provide information under rule 15c2-11. Moreover, the Commission emphasized that these newly exempt companies would remain subject to the antifraud provisions of federal securities law.<sup>40</sup>

Revisions to rules 12g-4 and 12h-3 provide that an issuer may now terminate its section 12(g) registration of a class of securities and discontinue filing reports under section 15(d) for that class when it is held of record by less than 300 persons or, alternatively, when it is held of record by less than 500 persons and the total assets of the issuer do not exceed \$5 million on the last day of each of the issuer's three most recent fiscal years.<sup>41</sup>

### PROPOSED NEW CRITERIA FOR REPORTING

On July 8, 1986, the SEC published its *Advance Notice of Proposed Rulemaking*, seeking comments on new criteria for Exchange Act reporting thresholds.<sup>42</sup> The Commission solicited comments on four possible alternative

40. See Asset Threshold Release, *supra* note 33, at 88,175. Rule 15c2-11 provides in relevant part:

It shall be a fraudulent, manipulative, and deceptive practice within the meaning of [§] 15(c)(2) of the Act, for a broker or dealer to publish any quotation for a security or, directly or indirectly, to submit any such quotation for publication, in any quotation medium (as defined in this section) unless: [the issuer has conformed with the registration requirements of the Securities Act] . . . .

41. Asset Threshold Release, *supra* note 33, at 88,175.

42. Exchange Act Release No. 23,407, *supra* note 34. The deadline for commentary was September 30, 1986. In a letter from the ABA Section of Corporation, Banking and Business Law to Jonathan C. Katz, Secretary, SEC (Sept. 30, 1986), certain ABA subcommittees proposed a two-tier reporting system that would provide a reduced level of reporting or exemption from reporting for issuers that meet the minimum threshold for the number of shareholders and value of total assets, if they meet certain market activity criteria. The proposal provided for an exemption from all reporting requirements where an issuer's fiscal year trading volume is less than 25 trades. For companies with more than 25 but less than some undetermined larger number of trades per year, the ABA recommended reporting requirements similar to the reduced set of filing requirements for issuers eligible for small offering registration using form S-18. The ABA further recommended that the current \$5 million and 500 shareholder threshold be retained if the two-tier system is adopted. However, if a one-tier system is retained, the ABA proposed raising the current total asset threshold to \$15 million and 1,000 shareholders. The ABA also discussed counting beneficial owners as shareholders if the total shareholder threshold is raised. Finally, the ABA suggested that the SEC consider reducing the three fiscal year requirement for suspension of reporting under the \$5 million and 500 shareholder test. The ABA reasoned that since an equity security is exempt from registration and reporting under § 12(g)(1)(A) when held by less than 300 shareholders at any time, it seems unnecessary to require issuers with total assets of less than \$5 million of equity securities held by between 300 and 500 shareholders to meet the \$5 million and 500 shareholder test for three

classification systems. Under the first system, the criteria would be based on the cost of compliance with Exchange Act registration and reporting provisions balanced against the issuer's capitalization or the market value of its securities. Under the second classification system, compliance would be suspended in cases where trading activity fell below a threshold level, e.g., less than twenty-five trades over the course of the past fiscal year.<sup>43</sup> Under the third system, the SEC proposed a tiered disclosure system: A bottom tier issuer would be exempt from registration; a middle tier issuer might only be required to file an annual report; and an upper tier issuer would be subject to the full disclosure requirements of the Exchange Act.<sup>44</sup> Under a fourth system, the Commission would simply further increase the present total asset level and total shareholder threshold based on cost-benefit data. The SEC invited commentators to research or generate empirical cost-benefit data to determine the best total assets threshold and noted that some commentators have already suggested that levels of \$15 million of total assets and 750 to 1000 shareholders would be appropriate.

The Commission concluded by stating that it had sufficient rulemaking authority under sections 12(h) and 13(c) of the Exchange Act to implement a new classification approach. However, to the extent commentators believe that more significant changes are warranted, the Commission stated it was "prepared to consider legislative proposals."<sup>45</sup>

## **TENDER OFFER DEVELOPMENTS**

### **AMENDMENTS TO TENDER OFFER RULES**

During 1986, several significant amendments were made to the SEC's tender offer rules. Generally, the amendments implemented certain of the recommendations made in 1983 by the SEC's Advisory Committee on Tender Offers ("SEC Advisory Committee")<sup>46</sup> and prohibited certain emerging strategies designed to obstruct a hostile takeover of one company by another.

consecutive years before being able to suspend their reporting under rules 12g-4 and 12h-3. The ABA recommended that the SEC reduce this suspension test to one fiscal year.

43. Exchange Act Release No. 23,407, *supra* note 34, at 88,177-78. The SEC recognized that a 25 trade per year threshold has been a longstanding recommendation of the ABA and stated that it was apparent that limited market activity in any issued security may indicate that there is insufficient public interest to justify Exchange Act reporting. *Id.*

44. *Id.* at 88,178. The SEC did not propose any criteria for delineating the cut-off for each tier and invited commentators to attempt to define the middle tier and address the appropriate reductions in reporting for issuers in this tier.

45. *Id.*

46. SEC Advisory Comm. on Tender Offers, Report of Recommendations, Fed. Sec. L. Rep. (CCH) No. 1028 (July 15, 1983) [hereinafter Report of Recommendations].

### *All Holders and Best Price Requirements*

In 1985, the SEC proposed to amend its tender offer regulations in response to the exclusionary issuer tender offer made by Unocal Corporation.<sup>47</sup> Unocal's self tender was successful as a defense to a hostile tender offer made by an affiliate of Mesa Petroleum Company. A condition of Unocal's offer was that no shares tendered by or on behalf of Mesa's affiliate would be accepted.<sup>48</sup> The district court in *Unocal Corporation v. Pickens* refused to enjoin the discriminatory self tender.<sup>49</sup> The court's conclusion that the self tender did not violate the Williams Act was based, in part, upon its inference that by failing to adopt earlier proposed rules regulating such offers, the SEC had concluded either that they were not authorized by the Williams Act or that they were not desirable as a matter of policy.<sup>50</sup> In July 1985, the SEC subsequently proposed the "all holders" and "best price" rules, emphasizing that they merely represented a codification of a longstanding SEC position.<sup>51</sup>

The "all holders" rule was finally adopted by the SEC in July 1986 by adding rule 13e-4(f)(8)(i) (for issuer tender offers) and rule 14d-10(a)(1) (for third-party tender offers).<sup>52</sup> The rule requires both issuers and third parties to make tender offers open to all holders of a class of securities. Its effect is to prohibit the type of exclusionary tender offer employed by Unocal against Mesa.

The all holders rule recognizes certain exceptions to the principle of equal opportunity. Since an offeror may be precluded from making an offer to residents of a particular state by that state's takeover or other statute, such residents may be excluded from the offer if the offer is prohibited by a state administrative or judicial authority after the offeror has made a good faith effort to comply with the statute.<sup>53</sup> An issuer may also make an offer directed only to holders of a specified number of its shares less than 100 (an odd-lot offer),

47. *Annual Review of Federal Securities Regulation, Significant 1985 Regulatory and Legislative Developments*, 41 Bus. Law. 925, 933-34 (1986) [hereinafter *Annual Review*]; Securities Act Release No. 6596, Exchange Act Release No. 22,199, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,798 (July 1985).

48. See *Unocal Corp., Offer to Purchase* 35 (Apr. 17, 1985).

49. 608 F. Supp. 1081 (C.D. Cal. 1985).

50. *Id.* at 1082. For the earlier SEC proposed all holders rules, see Exchange Act Release No. 14,234, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,380 (Dec. 7, 1977) and Exchange Act Release No. 16,112, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,182 (Aug. 16, 1979), with respect to issuer tender offers regulated under § 13(e); Exchange Act Release No. 16,385, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,374 (Nov. 29, 1979), with respect to issuer and third-party tender offers under § 14(e) of the Exchange Act.

51. See Securities Act Release No. 6595, Exchange Act Release No. 22,198, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,797, at 87,560 (July 1, 1985).

52. Securities Act Release No. 6653, Exchange Act Release No. 23,421, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,016 (July 11, 1986).

53. Rules 13e-4(f)(9)(ii), 14d-10(b)(2), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B, ¶ 24,288C, at 17,772.



provided that the offer is available to all such odd-lot holders.<sup>54</sup> In addition, issuer rescission offers registered under the Securities Act may be directed only to security holders whose securities may have been issued in violation of state or federal securities law.<sup>55</sup>

The all holders rule also specifically addresses foreign tender offers. While the rule requires an offeror to make its offer available to foreign persons, it imposes no additional dissemination requirements.<sup>56</sup> The all holders rule will not subject a foreign tender offer to the SEC's tender offer rules if it is not otherwise subject to them.<sup>57</sup>

At the time the all holders rule was adopted, the SEC also adopted a companion rule designed to provide equal treatment for a target company's shareholders, the "best price" rule. New rules 13e-4(f)(8)(ii) (for issuer tender offers) and 14d-10(a)(2) (for third-party tender offers) require that every tendering security holder in an issuer or third-party tender offer be paid the highest consideration paid by the offeror to any other security holder during the offer.<sup>58</sup> In tender offers providing for an election among different forms of consideration, all security holders must be given an equal right to make the election. Each security holder electing a form of consideration must be paid the highest consideration of that type paid to any other security holder.<sup>59</sup>

The best price rule also recognizes that state law may prevent compliance with the rule. If securities cannot be offered and sold under a particular state's blue sky laws after the offeror has made a good faith effort to register or qualify the offer and sale, an alternative form of consideration can be offered in that state without having to make that consideration available in other states.<sup>60</sup> If the alternative consideration is made available in a particular state, it need not be equal to the highest consideration paid to any other security holder outside of the state during the tender offer.<sup>61</sup> As noted above, an offeror placed in such a

54. Rule 13e-4(g)(5), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B. Odd-lot offers are generally made by issuers to holders of less than round lots (100 shares) to reduce the administrative costs of servicing small shareholders.

55. Rule 13e-4(g)(6), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11C.

56. Rules 13e-4(f)(9)(i), 14d-10(b)(1), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B, ¶ 24,288C, at 17,771.

57. See Securities Act Release No. 6653, *supra* note 52, at 88,192. The amendments as initially proposed expressly excepted tender offers in which the bidder was not a citizen or resident of the United States and did not use the mails or any means or instrumentality of interstate commerce or any facility of a national securities exchange. However, as a result of *Plessey Co. v. General Elec. Co.*, 628 F. Supp. 477 (D. Del. 1986), decided after the initial proposal, the SEC concluded that the express exclusion was no longer necessary. Securities Act Release No. 6653, *supra* note 52, at 88,192.

58. 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B, ¶ 24,288C, at 17,771.

59. Rules 13e-4(f)(10), 14d-10(c), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B, ¶ 24,288C, at 17,772.

60. Rules 13e-4(f)(11), 14d-10(d), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B, ¶ 24,288C, at 17,772.

61. Securities Act Release No. 6653, *supra* note 52, at 88,194.

dilemma can also elect under an exception to the all holders rule to exclude the security holders of that state from its tender offer.<sup>62</sup>

Another exemption is available for odd-lot tender offers and rescission offers by issuers. An issuer can pay different prices in an odd-lot tender offer if it is done under a uniformly applied formula based on market price.<sup>63</sup> In a rescission offer, an issuer need only pay the price paid by a security holder, plus legal interest.<sup>64</sup>

The Commission has reserved the general authority to exempt transactions on a case-by-case basis from the all holders and best price requirements if it determines that they do not constitute fraudulent, deceptive, or manipulative acts.<sup>65</sup>

A good deal of controversy surrounded the adoption of the all holders and best price provisions. Approximately half of the commentators opposed the all holders requirement for third-party tender offers and a substantial majority opposed the all holders requirement for issuer tender offers. The majority of those opposing the all holders requirement questioned the SEC's authority to adopt the rule.<sup>66</sup> Members of Congress also questioned the SEC's authority in this area.<sup>67</sup> The SEC's vote to adopt the amendment was a divided one. Commissioner Fleishman voted against applying the rule to issuer tender offers, and Commissioner Peters voted against applying the rule to either issuer or third-party tender offers.<sup>68</sup>

### ***Other Amendments to Tender Offer Rules***

In January 1986, the SEC adopted a series of amendments to conform the minimum offering, withdrawal, and proration periods for issuer tender offers with the periods for third-party offers.<sup>69</sup> At the time it adopted the all holders and best price requirements, the Commission also made additional amendments to the minimum offering and withdrawal periods applicable to issuer and third-party tender offers. As a result of all those amendments, the following requirements now apply to both issuer and third-party tender offers:

62. *Id.* at 88,193.

63. Rule 13e-4(g)(5), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11B.

64. Rule 13e-4(g)(6), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11C.

65. Rules 13e-4(g)(7), 14d-10(e), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11C, ¶ 24,288C, at 17,772. The SEC has indicated that it will consider applications for exemption from the best price rule in cases where (i) a foreign bidder wants to make an exchange offer to foreign security holders but a cash only offer to U.S. security holders, and (ii) a U.S. bidder wishes to make an exchange offer to U.S. security holders but a cash only offer to foreign security holders. Securities Act Release No. 6653, *supra* note 52, at 88,194.

66. Securities Act Release No. 6653, *supra* note 52, at 88,187.

67. *See Annual Review*, *supra* note 47, at 935 n.23.

68. *See* [July-Dec.] Sec. Reg. & L. Rep. (BNA) No. 18, at 997 (July 11, 1986).

69. Securities Act Release No. 6618, Exchange Act Release No. 22,788, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,954 (Jan. 14, 1986).

**(i) A tender offer must remain open for a minimum of twenty business days.**<sup>70</sup> While the twenty-business day minimum previously applied to third-party tender offers, two different minimum offering periods applied to issuer tender offers. A self tender made in response to or in anticipation of a third-party offer was subject to a twenty-business day minimum offering period. All other issuer tender offers were subject to a fifteen-business day period. The SEC adopted a uniform twenty-business day minimum offering period for all issuer tender offers, citing the complexity of recent issuer tender offers, the confusion created by disparate offering periods, and the desirability of eliminating the need to determine whether a self tender was made in anticipation of or in response to a third-party offer.<sup>71</sup>

**(ii) A tender offer must remain open for at least ten business days after the announcement of an increase or decrease in (a) the percentage of securities being sought or (b) the consideration offered or the dealer's soliciting fee.**<sup>72</sup> Prior to the amendments, the ten-business day minimum was triggered in third-party tender offers and in defensive tenders only by an increase in the consideration offered or in the dealer's soliciting fee. The Staff had taken the position that a decrease in the consideration offered constituted a new tender offer requiring the commencement of new time periods.<sup>73</sup> The amended rules provide a de minimus exception for purchases made of less than an additional two percent of the class upon expiration of a tender offer.<sup>74</sup>

**(iii) Tendered securities may be withdrawn at any time during the tender offer.**<sup>75</sup> Prior to the amendments, an issuer making a tender offer was required to permit a tendering security holder to withdraw his securities during a period of no less than ten business days after the commencement of its tender offer. The minimum withdrawal period for third-party tender offers was fifteen business days. Different additional minimum withdrawal periods were also applicable upon the commencement of a competing tender offer: seven business days for issuer tender

70. 17 C.F.R. §§ 240.13e-4(f)(1)(i), 240.14e-1(a) (1986).

71. Securities Act Release No. 6618, *supra* note 69, at 87,974-75.

72. 17 C.F.R. §§ 240.13e-4(f)(1)(ii), 240.14e-1(b) (1986). The SEC Advisory Committee had recommended that the minimum offering period should not terminate for five days after the announcement of an increase in price or number of shares sought. Report of Recommendations, *supra* note 46, at 28-29.

73. See Securities Act Release No. 6595, Exchange Act Release No. 22,198, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,797, at 87,564 (July 1, 1985).

74. Rules 13e-4(f), 14e-1, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11, ¶ 24,295, at 17,817.

75. Rules 13e-4(f)(2)(i), 14d-7(a), 3 Fed. Sec. L. Rep. (CCH) ¶ 23,703B, at 17,245-11A, ¶ 24,287A, at 17,767-3. The SEC Advisory Committee recommended that the minimum withdrawal period be the same as the minimum offering period. Report of Recommendations, *supra* note 46, at 27-28.

offers and ten business days for third-party tender offers. The amendments eliminated the advantages previously enjoyed by issuers with respect to the shorter time periods. In addition, the amendments eliminated the extension of withdrawal periods beyond the expiration date of a tender offer, simplifying the process and eliminating the ability of a competing bidder to extend the withdrawal period for an initial tender offer.

**(iv) Securities tendered at any time during the tender offer must be accepted on a pro rata basis.**<sup>76</sup> Prior to the amendments, a third-party bidder was required to purchase all securities tendered during its offer on a pro rata basis, but an issuer needed only to purchase pro rata those securities that were tendered during the first ten business days of its offer. The SEC concluded, agreeing with a recommendation of the SEC Advisory Committee, that the shorter proration period for issuer tender offers pressured security holders to tender quickly into the issuer's tender offer.<sup>77</sup> However, by adopting the amendment, the SEC has, in the case of a defensive issuer tender offer, shifted the advantage from the issuer to the third party since the third-party's offer and proration period will expire before the issuer's.

## CONCEPT RELEASE

In July 1986, the SEC published a concept release seeking comments on (i) the regulation of large-scale purchases of target company shares during or shortly after a tender offer, (ii) the regulation of "poison pill" plans, and (iii) a proposed "self-governance" exemption permitting a corporation to exempt itself from the all holders rule and other tender offer regulations.<sup>78</sup>

Currently, a bidder is prohibited from purchasing securities outside of its tender offer from the time the offer is announced until the time the offer expires.<sup>79</sup> However, the issuer and third parties other than the bidder are free to purchase the target company's securities while the bidder's tender offer is pending. In addition, a bidder may purchase target company shares privately or in the open market once its tender offer has terminated. In the concept release, the SEC expressed its concern with the type of large-scale acquisition programs involved in two decisions, *SEC v. Carter Hawley Hale Stores*<sup>80</sup> and *Hanson Trust PLC v. SCM Corp.*<sup>81</sup> In *Carter Hawley Hale*, the SEC was unsuccessful

76. 17 C.F.R. §§ 240.13e-4(f)(3), 240.14d-8 (1986). The SEC Advisory Committee recommended that the minimum prorationing period be the same as the minimum offering period. Report of Recommendations, *supra* note 46, at 27-28.

77. Securities Act Release No. 6618, *supra* note 69, at 87,977.

78. Exchange Act Release No. 23,486, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,018 (July 31, 1986).

79. 17 C.F.R. § 240.10b-13 (1986).

80. 760 F.2d 945 (9th Cir. 1985) (open-market purchases by issuer of over 50% of its stock within an eight-day period).

81. 774 F.2d 47 (2d Cir. 1985) (private and open-market purchases by third-party bidder of 25% of target company's stock on day it terminated its tender offer).

in asserting that a target company's defensive, large-scale, open-market purchases of its securities were subject to the Williams Act. In *Hanson Trust*, the Second Circuit similarly determined that a bidder's large-scale, open-market, and privately negotiated purchases of target company shares on the day it terminated its tender offer were not subject to the Williams Act. After the publication of the concept release, Campeau Corporation, within thirty minutes of terminating a tender offer for the shares of Allied Stores Corporation, purchased forty-eight percent of Allied's stock on the open market.<sup>82</sup> The concept release solicited comments on a broad range of issues relating to such large-scale acquisitions and on a specific proposal to require that all substantial acquisitions, e.g., ten percent or more, of a target company's securities during and for a certain period after a tender offer be made only by means of a formal tender offer pursuant to the Williams Act.

The concept release also solicited views on the effect of poison pill plans and the appropriate regulatory response, if any.<sup>83</sup> The release reviewed the differing views on the beneficial and detrimental effects of poison pill plans adopted by corporations as defensive measures without shareholder approval. The release also discussed the differing judicial treatment of the plans. One regulatory response suggested by the SEC was to require shareholder approval of poison pill plans. The SEC specifically requested comments on whether it should intervene in an area that has traditionally been a province of state corporation law.

The final topic of the concept release was a proposed self-governance exemption from the all holders requirement and other tender offer regulations. Pursuant to this concept, the exemption would be accomplished by means of an amendment to the corporation's charter. SEC Commissioner Joseph Grundfest first publicly proposed this approach in January 1986 in the SEC's consideration of the all holders rule.<sup>84</sup>

## LEGISLATIVE RECOMMENDATIONS

At the beginning of 1986, the only pending legislative recommendation of the SEC relating to tender offers was a proposal to amend section 13(d) of the Exchange Act to close the schedule 13D window. Presently, section 13(d) requires the filing of a statement of beneficial ownership within ten days after the acquisition of over five percent of a class of equity securities.<sup>85</sup> No restrictions exist on the ability to acquire additional shares during the ten-day period

82. Wall St. J., Nov. 4, 1986, at 2, col. 3.

83. A poison pill is generally a right distributed by a corporation to its shareholders. The rights, which can be in any one of a wide variety of securities, have only nominal value until the occurrence of a triggering event, such as a tender offer. Once triggered, the rights can have a significant adverse economic impact on a hostile acquirer. See Exchange Act Release No. 23,486, *supra* note 78, at 88,203-06.

84. SEC Defers Action on All-Holders Rule, [Jan.-June] Sec. Reg. & L. Rep. (BNA) No. 18, at 31 (Jan. 10, 1986).

85. 15 U.S.C. § 78m(d) (1982).

before the beneficial ownership statement is filed. In January 1986, the SEC modified its earlier proposal to amend section 13(d). Its amended recommendation would simply reduce the filing deadline from ten days to two days, thereby reducing the window period.<sup>86</sup>

### OTHER ACTIONS

At its January 9, 1986 meeting, the SEC directed its Staff to meet with each commissioner to see whether a consensus existed on the definition of a tender offer.<sup>87</sup> The SEC also decided not to take or recommend action with respect to a variety of takeover matters.<sup>88</sup>

The SEC's Office of the Chief Economist published two studies on the economic effects of poison pills<sup>89</sup> and one study on junk bond financing.<sup>90</sup> Both of the poison pill studies generally concluded that poison pills were harmful to target company shareholders. The junk bond review concluded that there was no cause for excessive concern about the current levels of junk bond financing in takeovers and that no need existed for new regulation.

### FEDERAL RESERVE BOARD JUNK BOND RULE

On January 10, 1986, the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") issued an interpretive rule concluding that debt securities issued by a shell corporation to finance its acquisition of margin stock are indirectly secured by that stock for purposes of the restrictions on lending contained in the margin regulations.<sup>91</sup> Those restrictions limit the amount of debt to one half of the market value of the stock being acquired and, as a result, significantly limit the amount of debt that can be issued by such single purpose

86. Office of the Gen. Counsel, Div. of Corp. Fin., Securities and Exchange Comm'n, *Recent Developments in Tender Offer Regulation; SEC Rulemaking; Legislative Proposals; State Activity, and the Business Judgment Rule*, 18th Ann. Inst. on Sec. Reg. 9, 26 (Prac. L. Inst. 1986).

87. *SEC Defers Action*, *supra* note 84, at 32.

88. The SEC decided not to take or recommend action that would, inter alia: (i) prohibit two-tier or partial tender offers, golden parachutes, lockups, greenmail, junk bond financing of tender offers, or antitakeover charter and bylaw amendments; (ii) require prior approval of a tender offer by a bidder's shareholders; (iii) require various new corporate approvals prior to, or in connection with, a tender offer; (iv) require all acquisitions made by a holder of a specified percentage of an issuer's securities to be made only by means of a tender offer; and (v) regulate the activities of arbitrageurs. Office of the Gen. Counsel, *supra* note 86, at 67-69.

89. Office of the Chief Economist, Securities and Exchange Comm'n, *A Study on the Economics of Poison Pills*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,971 (Mar. 5, 1986); Office of the Chief Economist, Securities and Exchange Comm'n, *The Effects of Poison Pills on the Wealth of Target Shareholders* (Oct. 23, 1986).

90. Office of the Chief Economist, Securities and Exchange Comm'n, *Noninvestment Grade Debt as a Source of Tender Offer Financing*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,011 (June 20, 1986). The term "junk bond" refers to debt that is not rated as investment grade.

91. Board of Govs. of the Fed. Res. Sys. Docket No. R-0562, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,952 (Jan. 10, 1986).

acquisition vehicles. However, the restrictions apply only to shell corporations that have no business operations other than making the acquisition and that have substantially no assets or cash flow to support the credit other than the stock to be acquired. In addition, the restrictions do not apply if (i) the purchasers of the debt are in good faith looking to some credit support other than the margin stock as collateral, such as a guarantee, (ii) a merger agreement exists between the borrower and the target company prior to the purchase of the debt, or (iii) the obligation of the purchasers of the debt to advance funds is contingent upon the borrower's acquisition of a minimum number of shares necessary to effect a merger with the target company without the approval of the target company's directors or shareholders.

Because of the limitations on the application of the rule, it is not expected that it will significantly affect the use of debt securities to finance takeovers.

## **REGULATION OF BROKER-DEALERS**

### ***THE SECTION 28(e) SAFE HARBOR AND SOFT DOLLAR RULES***

In April 1986, the SEC issued an interpretive release (the "1986 Release") concerning the scope of section 28(e) of the Exchange Act and the safe harbor provision for persons who exercise investment discretion over certain accounts and use commission dollars of these accounts to obtain research.<sup>92</sup> These arrangements to obtain research or other products and services in addition to execution services by broker-dealers have come to be referred to as "soft dollar" arrangements.

The 1986 Release provides: (i) a clarification of the SEC's interpretation of the phrase "brokerage and research service"; (ii) discussion of the provision of third-party research; (iii) reiteration of disclosure obligations of money managers in soft dollar arrangements; (iv) the SEC's view regarding best execution obligations of fiduciaries for their clients' transactions; and (v) the views of the SEC and the Department of Labor regarding directed brokerage practices by sponsors of employee benefit plans.

Section 28(e) of the Exchange Act was adopted by Congress in 1975.<sup>93</sup> It was intended to provide a safe harbor for investment managers to select brokers on

92. Exchange Act Release No. 23,170, 4 Fed. Sec. L. Rep. (CCH) ¶ 26,579A (Apr. 23, 1986). Under § 202(a)(11)(C) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11)(C) (1982), the term "investment adviser" excludes "any broker or dealer whose performance of such [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." The Commission interpreted "special compensation" in Advisers Act Release No. 626, Exchange Act Release No. 14,714, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,577 (Apr. 27, 1978).

93. Section 28(e) provides in part:

No person using the mails or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to [June 4,

the basis of service. With the elimination of fixed minimum commission rates in 1975, there was a fear that investment managers might feel compelled to pay the lowest commission rate available even if the client would benefit from the payment of a higher rate. This might result if the client received the benefit of other services such as research. Investment managers were concerned that payment for such services might be deemed a breach of their fiduciary duties. The adoption of section 28(e) acknowledges that brokers provide something of value to an investment manager's account when they provide special services such as research, and that the use of commission dollars for these services in certain circumstances is appropriate.

The 1986 Release will also replace a 1976 interpretive release, which stated that the safe harbor did not protect anything that is readily and customarily available and offered to the general public on a commercial basis.<sup>94</sup> The Commission felt that this standard was too difficult to apply and was unduly restrictive.

### ***Interpretation of Brokerage and Research Services***

In place of the 1976 interpretive release standard, the 1986 Release now states that the controlling principle to be used to determine whether something is research is whether it provides lawful and appropriate assistance to the money manager in the performance of his investment decisionmaking responsibilities.

This standard suggests that money managers must look at the actual use to which a product or service is put in determining whether it is research. As noted by the Commission, "What constitutes lawful and appropriate assistance in any particular case will depend on the nature of the relationships between the various parties involved and is not susceptible to hard and fast rules."<sup>95</sup> Certain products that had previously been disapproved for purposes of soft dollars, such as computer hardware and quotation equipment, may now be purchased with commission dollars to the extent they are actually used in investment decision-making. Where a product has a mixed use between research and nonresearch, the Commission allows a reasonable allocation between the uses; the portion allocable to research uses may be paid for with commission dollars and funds. The Commission further clarifies that fees for research seminars or similar

1975], solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

94. Exchange Act Release No. 12,251, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,407 (Mar. 24, 1976).

95. Exchange Act Release No. 23,170, *supra* note 92, at 19,447-5.



programs can be paid for with commission dollars, but that nonresearch expenses such as travel costs, hotels, meals, and entertainment are not within the safe harbor. Significantly, the Commission recognized that the research/nonresearch allocation task may be complex and believes that fiduciaries will meet appropriate standards if they make a "good faith attempt, under all the circumstances, to allocate the anticipated uses of a product."<sup>96</sup>

### ***Third-Party Research***

In the 1986 Release, the Commission also discusses the issue of the provision of research to money managers by someone other than the executing broker ("third-party research") and summarizes past positions in this area. It is not necessary that a broker produce the research services "in-house," but the services must be "provided by" the broker. Section 28(e) protects (i) arrangements in which the money manager participates in selecting the third-party research services or products to be provided by the broker, and (ii) the payment of commissions made in good faith to an introducing broker for execution and clearing performed in whole or in part by that broker's normal and legitimate correspondent. But arrangements in which a broker pays bills incurred by a money manager in its direct dealings with a third-party provider of research or other services are not protected by section 28(e). These positions reflect policies that have been followed by the Staff rather than a change in policy.

### ***Disclosure Obligations of Soft Dollar Arrangements***

In the portion of the 1986 Release on soft dollars, the Commission also reiterates present policies, relating to disclosure obligations of money managers, with particular reference to the Investment Advisers Act of 1940 (the "Advisers Act") and the Investment Company Act of 1940 (the "Investment Company Act").

The Commission notes that in providing clients with material information about the adviser's brokerage allocation policies and practices pursuant to item 12 of part II of form ADV, where the value of products, research, and services given to the adviser by a broker is a factor in its decision to allocate brokerage, the adviser need not list individually each product, item of research, or service received but can state the types of these items obtained "with enough specificity so that clients can understand what is being obtained."<sup>97</sup> The Commission further notes, however, that "[d]isclosure to the effect that various research reports and products are obtained would not provide the specificity required."<sup>98</sup> Also, advisers are instructed that these disclosure requirements apply to *all* soft dollar arrangements, regardless of whether they fall within section 28(e) or not.

96. *Id.*

97. *Id.* at 19,447-8 n.29.

98. *Id.*

### ***Investment Company Act Disclosure***

Following the pattern of the disclosure sections concerning the Advisers Act, this portion of the 1986 Release reviews previously enacted disclosure requirements and other statutory provisions under the Investment Company Act as they may relate to soft dollar situations. In its discussion of the statutory provisions, the Commission emphasized that section 17(e)(1) of the Investment Company Act arguably would be violated by most soft dollar arrangements but that the section 28(e) safe harbor preempts section 17(e)(1) for those arrangements that come within it.<sup>99</sup>

### ***Best Execution***

Citing the language of a 1972 Release<sup>100</sup> in connection with the statement that a money manager has an obligation to obtain "best execution," the SEC noted that the money manager must "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."<sup>101</sup> The Commission next pointed out that, in placing brokerage, the money manager should consider the full range and quality of a broker's services. Among these services are "the value of research provided as well as execution capability, commission rate, financial responsibility and responsiveness to the money manager."<sup>102</sup> The Commission then used the release to remind money managers that the key factor in the determination of best execution is not the lowest possible commission cost, but "whether the transaction represents the best qualitative execution for the managed account."<sup>103</sup>

### ***Directed Brokerage Practices***

The final topic for discussion in the 1986 Release was the practice by employee benefit plan sponsors of directing brokerage. In this regard, the Commission emphasized that the safe harbor of section 28(e) is available only to persons who exercise investment discretion as that term is defined in the Advisers Act and that a pension plan sponsor that retains a money manager to make investment decisions is not exercising investment discretion. Therefore, the directing of brokerage by the plan sponsor could not come within section 28(e) and neither the plan sponsor, the money manager, nor the broker-dealer could rely on the safe harbor. The release then notes that the Department of Labor has indicated that the direction of brokerage by a plan sponsor for purposes that do not exclusively benefit the employee benefit plan would constitute per se violations of the Employee Retirement Income Security Act of

99. *Id.* at 19,447-11.

100. Exchange Act Release No. 9598, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,776 (May 9, 1972).

101. Exchange Act Release No. 23,710, *supra* note 92, at 19,447-12.

102. *Id.*

103. *Id.*

1974 ("ERISA"). The Commission indicated that some money managers and brokers that engage in directed brokerage transactions have required the pension plan to represent to them in writing that such transactions are for the exclusive benefit of the plan and its beneficiaries.

The Commission then raised the concern regarding the broker's obligation, pursuant to rule 10b-10 under the Exchange Act in confirming transactions with customers, to provide disclosure of certain sponsor-directed brokerage arrangements where a rebate is involved. As noted by the Commission, "At least in the case of a cash rebate, the confirmation is false if it does not at a minimum provide disclosure that a portion of the commission was returned to the plan."<sup>104</sup> The Commission also noted in that regard, however, that the recordkeeping rule, rule 17a-3(a)(8) under the Exchange Act, requires broker-dealers to keep copies of notices of all debits and credits for securities, cash, and other items for the account of customers. It stated that this provision would require that the broker document any rebating arrangements that it entered into with plan sponsors.

Finally, although the Commission noted that the safe harbor of section 28(e) allows a money manager, in determining the reasonableness of commissions paid, to consider the benefits derived by the account paying the commission and by other accounts, the Commission believes that securities laws' antifraud provisions make it illegal for a money manager or broker-dealer to use one client's commissions to fund an undisclosed rebate to another client. The Commission drew specific attention to the problems of aggregating orders for discretionary accounts and stated that in such cases serious concerns are raised under the antifraud provisions where a money manager or broker-dealer aggregates directed and nondirected orders, unless it can demonstrate that it has not imposed disadvantages on one client's account in order to fund a rebate to another client. The Commission concluded that the money manager and the broker-dealer must have control and records systems to assure that such commingling does not occur.

### *SEC RULE 10b-10: DISCLOSURE OF MARK-UPS AND MARK-DOWNS*

Under amendments to Exchange Act rule 10b-10<sup>105</sup> governing customer confirmation disclosure, the Commission is now requiring a broker-dealer to disclose the trade price and resulting mark-up (or mark-down) in principal transactions in reported securities.

Prior to the amendments, rule 10b-10 permitted broker-dealers in a principal transaction with a customer, other than riskless principal transactions, to confirm the transaction at a single net price to the customer. The net price included the trade price and the mark-up or commission equivalent. In agency

104. *Id.* at 19,447-13.

105. Exchange Act Release No. 22,397, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,912 (Sept. 11, 1985) (effective Mar. 17, 1986).

transactions, however, no amendment to the rule was necessary because the broker-dealer already was required to disclose on the confirmation both the transaction price and the commission.

Under the amendment, a broker-dealer in a principal transaction must disclose on the confirmation the customer's reported trade price, which for trades in over-the-counter/National Market System Securities would be the price the broker-dealer reported pursuant to the NASD real time last sale reporting requirements, and for listed securities would be the price reported pursuant to exchange requirements. The broker-dealer is also required to disclose the mark-up (or mark-down) or commission equivalent.

In adopting these amendments, the Commission concluded that the new disclosure will allow investors to assess the charges of broker-dealers and shift their business accordingly if they desire. The Commission also stated that the new disclosure requirements would enhance the ability of investors to monitor execution quality by being able to determine the actual price at which their trade occurred. As noted in the adopting release, "While achieving the most favorable net price is the rational goal of investors, disclosure of the separate components of this price allows the investor to assess each component of an execution and determine where improvement can be achieved."<sup>106</sup> The new amendments will also provide for equivalent disclosure to all customers effecting transactions in reported securities whether executed on an agency or a principal basis.

## OTHER DEVELOPMENTS

The Commission's approval of proposals by the New York and American Stock Exchanges to permit specialists to be affiliated with "approved persons" engaged in a securities business is covered later in this article in the section on Market Regulatory Developments. For a discussion of the Commission's effort to regulate brokerage activities by banks under SEC rule 3b-9, and the decision of the Second Circuit Court of Appeals finding that the Commission did not have the authority to do so under the Exchange Act, see *Significant 1986 Court Decisions* in the second part of this survey.

## REGULATION OF GOVERNMENT SECURITIES DEALERS

Despite the fact that the government securities market in the United States is considered to be the most efficient securities market in the world, with the spread between bid and asked prices and the brokerage commissions being a fraction of those in other securities markets, several firms that traded these securities failed with substantial losses to investors. Congress and certain regulators decided to intervene with proposals for more formal regulation of this market.

106. *Id.* at 87,775.

In 1985, the SEC issued a release requesting comments on oversight of the U.S. government and agency securities markets and dealers.<sup>107</sup> Also in that year, both houses of Congress and the Treasury Department introduced or approved differing proposals for the regulation of the government securities industry. In 1986, the Senate approved a compromise bill that had already been approved by the House of Representatives,<sup>108</sup> and the bill was signed by President Reagan on October 28, 1986 (the "Government Securities Act").

The new law requires the registration of all unregistered government securities brokers and dealers and the filing of notices by currently regulated government securities brokers and dealers. It directs the Secretary of the Treasury to issue regulations relating to, among others, financial responsibility, recordkeeping, and custody and use of customer securities. It also authorizes the SEC and federal bank regulators to inspect the financial records and transactions of government securities brokers and dealers who will be required to file annually a certified balance sheet and income statement. Finally, the SEC and federal bank regulators would have enforcement powers under the Government Securities Act.

107. Exchange Act Release No. 21,959, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,760 (Apr. 19, 1985).

108. Pub. L. No. 99-571, 1986 U.S. Code Cong. & Admin. News (100 Stat.) (Oct. 28, 1986) (amending the Exchange Act). See discussion in [July-Dec.] Sec. Reg. & L. Rep. (BNA) No. 18, at 1497 (Oct. 17, 1986).

As part of the new legislation, certain key definitions were included: “government securities,”<sup>109</sup> “government securities broker,”<sup>110</sup> and “government securities dealer.”<sup>111</sup>

109. Section 102(d) of the Government Securities Act amends § 3(a) of the Exchange Act to define the term “government securities” in new § 3(a)(42) as:

- (A) securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States;
- (B) securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors;
- (C) securities issued or guaranteed as to principal or interest by any corporation the securities of which are designated, by statute specifically naming such corporation, to constitute exempt securities within the meaning of the laws administered by the Commission; or
- (D) for purposes of §§ 15C and 17A, any put, call, straddle, option or privilege—
  - (i) that is traded on one or more national securities exchanges; or
  - (ii) for which quotations are disseminated through an automated quotation system operated by a regulated securities association.

110. Section 102(d) of the Government Securities Act amends § 3(a) of the Exchange Act to define the term “government securities broker” in new § 3(a)(43) as:

- any person regularly engaged in the business of effecting transactions in government securities for the account of others, but does not include—
  - (A) any corporation, the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection; or
  - (B) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market’s affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to such person’s futures-related business.

111. Section 102(d) of the Government Securities Act amends § 3(a) of the Exchange Act to define the term “government securities dealer” in new § 3(a)(44) as:

- any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise, but does not include—
  - (A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business;
  - (B) any corporation the securities of which are government securities under subparagraph (B) or (C) of paragraph (42) of this subsection;
  - (C) any bank, unless the bank is engaged in the business of buying and selling government securities for its own account other than in a fiduciary capacity, through a broker or otherwise; or
  - (D) any person registered with the Commodity Futures Trading Commission, any contract market designated by the Commodity Futures Trading Commission, such contract market’s affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the Commodity Futures Trading Commission, has determined by rule or order to be incidental to such person’s futures-related business.

## *REGISTRATION OF GOVERNMENT SECURITIES BROKERS AND DEALERS*

Each broker-dealer currently registered with the SEC and regulated financial institutions will be required to file a notice with the appropriate regulators that it is a government securities broker or dealer. This notice is to be in a form and contain such information regarding government securities brokers or dealers as the Federal Reserve Board, the SEC, and the appropriate regulatory agency shall, by rule, prescribe as necessary or appropriate in the public interest or for the protection of investors. A notice must also be filed when a government securities broker or dealer ceases to act as such.

Currently unregistered government securities brokers or dealers will be required to register with the SEC. The application for registration is being developed by the SEC and will contain such information and documents as the SEC by rule may prescribe as necessary or appropriate in the public interest for the protection of investors. Within forty-five days of the date the application is filed, or such longer period to which applicant may consent, the SEC must grant the registration or institute proceedings to determine whether the registration should be denied. If the SEC institutes proceedings, it must give the applicant notice of the grounds for denial. An opportunity for a hearing must be given and the proceedings must be concluded within 120 days of the application's filing date.

## *TREASURY RULEMAKING AUTHORITY*

The Government Securities Act authorizes the Treasury to propose and adopt rules to effect the purposes of the act. The three categories of rules specified in the Government Securities Act are: (i) rules to provide safeguards with respect to financial responsibility and related practices of government securities brokers or dealers, "including, but not limited to, capital adequacy standards, the acceptance of custody and use of customers' securities, the carrying and use of customers' deposits or credit balances, and the transfer and control of government securities subject to repurchase agreements and in similar transactions";<sup>112</sup> (ii) rules requiring government securities brokers and dealers to make reports and furnish records to their regulatory authority and to file a certified balance sheet and income statement with the appropriate regulator at least annually together with such other financial information concerning financial condition as the Treasury Department may require; and (iii) rules requiring that records be made and kept.

Rules enacted under the act must be designed to prevent fraudulent and manipulative acts and practices and protect the integrity, liquidity, and efficiency of the markets; they shall not permit unfair discrimination between customers, issuers, and government securities brokers or dealers, or impose an unnecessary or inappropriate burden on competition. In promulgating rules

112. Government Securities Act § 101.

under the Government Securities Act, the Treasury Department is given authority to classify government securities brokers or dealers and may determine not to apply, in whole or in part, certain of the rules or to impose more or less stringent standards on different classes of government securities brokers or dealers.

Treasury is also given rulemaking authority over depository institutions that are not government securities brokers or dealers with respect to safeguarding and use of government securities. These rules shall provide for the adequate segregation of government securities, including securities subject to repurchase agreements and other similar transactions.

Treasury's rulemaking authority expires in 1991 and must be renewed or transformed at that time.

## ***ENFORCEMENT***

The SEC is given enforcement authority over any government securities broker or dealer currently registered as a broker-dealer with the SEC or required to be registered under the Government Securities Act. Enforcement for all government securities brokers and dealers subject to regulation by a federal bank or thrift regulator is vested with such regulator.

Pursuant to their enforcement powers, the appropriate regulator of the government securities broker or dealer may censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, revoke the registration of, or bar from acting as, a broker or dealer for violations as specified in the Government Securities Act.

## ***IMPLEMENTATION***

The Treasury Department and appropriate regulatory authorities are required to publish for notice and comment rules and regulations to implement the Government Securities Act within 120 days of the effective date of the act. The regulations are scheduled to become effective as temporary regulations within 210 days and to become final within 270 days of the effective date of the new law.

## ***SECURITIES MARKET REGULATORY DEVELOPMENTS***

Although several market regulatory initiatives were undertaken this past year, 1986 could not be characterized as a year in which many market regulatory problems were resolved. Of the two most significant actions taken in this arena—the New York Stock Exchange's ("NYSE") rule proposal on disparate voting rights and the Commission's efforts to curb the volatility of trading on "triple-witching" Fridays—one development is in a proposal stage and the other can only be characterized as experimental. Two other market regulatory advancements slated to become effective in 1986—unlisted trading on



exchanges in over-the-counter securities and side-by-side exchange trading of over-the-counter options and underlying securities<sup>113</sup>—experienced limited or no progress. Definitive regulatory action was not totally absent this past year, however, as the Commission approved a new interpretive release for rule 10b-6 and a modification to New York and American Stock Exchange rules that had previously discouraged integrated retail brokerage houses from operating specialist units.

### *DISPARATE VOTING RIGHTS FOR NYSE LISTED SECURITIES*

It has continued to be a major issue whether a change should be effected in the NYSE's listing requirements that dictate one vote per share of common stock. The question whether NYSE listed companies should be required to maintain equal voting rights among dual classes of common stock encompasses the issues of appropriate defense strategies for unnegotiated tender offers, acceptable bases for intermarket competition among the self-regulatory organizations, the wisdom of widening the chasm between corporate ownership and corporate control, and the related issue of to whom American corporations are accountable.

Although the NYSE Listed Company Manual does not expressly prohibit listing of a company with disproportionate or disparate voting rights, since the 1920s the exchange has denied listing to a company that authorizes a class of common stock having more votes per share than another class of common stock. This listing standard has come to be referred to as the "one share, one vote" rule or policy. It is based upon the general rule in the NYSE Manual providing that the exchange may refuse to list a class of stock that has unusual voting provisions, such as provisions that tend to nullify or restrict the voting rights of another class of stock.<sup>114</sup> This listing standard has been imposed even though state corporation laws generally permit dual voting rights.<sup>115</sup>

In 1984, in response to the adoption by several NYSE listed companies of charter provisions creating classes of common stock with unequal voting rights, the NYSE initiated a process to review its one share, one vote rule. At the same time, the NYSE imposed a moratorium on enforcing this policy. The recapitalization amendments that NYSE listed companies were adopting were in part

113. For a discussion of these developments, see *Annual Review*, *supra* note 47, at 944-54.

114. NYSE Listed Company Manual § 313.00 (1983). Subsection (A) provides for denial of listing of *non-voting* stock; subsections (B) and (C) warn that the exchange may object to restriction of voting rights by the use of a voting trust, irrevocable proxies, or unusual voting provisions; and subsection (D), referring to voting power divided "between the common stock and one or more other classes of stock," states that "[i]f the voting power of such other classes is in excess of such reasonable relationships, the Exchange may refuse to authorize listing of the common stock." The NYSE Manual also provides that "the Exchange would normally give consideration to delisting a security for a Company when . . . a class of non-voting common stock is [c]reated." *Id.* § 802.00.

115. For example, Delaware provides for one vote for each share "[u]nless otherwise provided in the certificate of incorporation." Del. Code Ann., tit. 8, § 212(a) (1984).

stimulated by management's desire to discourage hostile takeovers. On the other hand, the NYSE's concern with its one share, one vote requirement was generated by the competitive disadvantage at which such a listing requirement placed the exchange vis-a-vis other market centers.<sup>116</sup>

The initial result of the NYSE review was a subcommittee report presented to the Public Policy Committee of the NYSE board of directors in January 1985 recommending that issuers with dual voting rights common stock be permitted to list on the NYSE provided that specified conditions were met.<sup>117</sup> Those conditions required that: (i) the differential voting rights be approved by two-thirds of all shares entitled to vote on the proposition; (ii) the issuer's board have a majority of independent directors at the time that the differential voting is approved and a majority of those directors approve the proposal, or, if the issuer's board has less than a majority of independent directors, then all independent directors approve the proposal; (iii) the voting differential ratio be no more than ten to one; and (iv) the rights of the two classes of stock be substantially the same except for the voting power per share.

Since the publication of this report, various efforts have been taken to create a uniform shareholder voting rights standard among the NYSE, the American Stock Exchange ("Amex"), and NASD. The House of Representatives held hearings on the disparate voting rights issue.<sup>118</sup> In June 1985, legislation was introduced in Congress to impose a one share, one vote rule on publicly traded securities.<sup>119</sup> The NYSE, Amex, and NASD were encouraged by congressmen and Commission officials to explore the possibility of adopting uniform listing standards regarding shareholder rights. The legislation was not reported out of committee and the efforts to devise uniform listing standards failed.

In September 1986, citing its inability to influence listing standards in other trading centers as well as its reluctance to "unilaterally maintain" its own unique one share, one vote listing requirements,<sup>120</sup> the NYSE submitted to the Commission a proposal to modify its listing requirement regarding dual voting common stock.<sup>121</sup> Pursuant to section 19(b) of the Exchange Act, self-regulatory organization rule changes (other than those that are solely administrative, deal with fee structures, or are merely repetitive of a current policy) must be

116. NASD has no voting rights requirement for securities quoted on NASDAQ. The American Stock Exchange's listing standards regarding dual voting common stock are less stringent than those of the NYSE. American Stock Exchange Company Guide § 122, 2 American Stock Exchange Guide (CCH) ¶ 10,022 (1985).

117. NYSE, Initial Report of the Subcomm. on Shareholder Participation and Qualitative Listing Standards 3 (1985).

118. *Impact of Corporate Takeovers: Hearings before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 99th Cong., 1st Sess. 1110-1234 (1985).

119. H.R. 2783, 99th Cong., 1st Sess. (1985); S. 1314, 99th Cong., 1st Sess. (1985).

120. Letter from John J. Phelan, Jr., Chrm./CEO, NYSE, to John Shad, Chrm., SEC 3 (Sept. 16, 1986), cited in Exchange Act Release No. 23,803, 51 Fed. Reg. 41,715, 41,716 & n.12 (1986).

121. See Exchange Act Release No. 23,724, 51 Fed. Reg. 37,529 (1986) for notice of the proposed rule change.

approved by the Commission.<sup>122</sup> In compliance with its section 19(b) obligations, the Commission published the NYSE proposal for public comment in October 1986.<sup>123</sup> One month later, in view of the "importance and complexity of the issues raised by the proposed rule change," the Commission announced its determination to hold public hearings on the proposals in December 1986 and to seek additional comments on specific issues relating to the proposal.<sup>124</sup>

Most of the standards suggested by the NYSE subcommittee as conditions for the listing of dual voting stock were either eliminated or relaxed in the rule proposal made by the NYSE in September. Instead of requiring a two-thirds shareholder approval of disparate voting rights provisions, the actual NYSE rule proposal requires a simple majority. Further, in instances where independent directors do not comprise a majority of the board, there no longer would be a requirement for unanimous independent director approval. In addition, the NYSE proposal would not limit voting disproportionality between classes of common stock to a ten to one ratio. The NYSE chose not to incorporate within its proposal other shareholder safeguards, such as a requirement for periodic reaffirmations of the dual voting rights by successive bodies of shareholders or independent directors. The NYSE considered such a requirement but rejected it as infeasible. Excluded altogether from compliance with the proposed standards would be stock with disparate voting rights outstanding at the time the issuer first became a public company or that was distributed pro rata among the company's shareholders in a "spin-off" of assets.

The issues upon which the Commission has sought additional comment reflect an open-minded approach by the Commission to the entire one share, one vote issue. These issues cover a broad range of topics: the wisdom of requiring the NYSE to retain its one share, one vote rule; the adequacy of the proposed standards for allowing dual voting classes of common stock; and the wisdom and necessity of applying a uniform one share, one vote rule to all securities markets.<sup>125</sup> A related question raised by the Commission concerns the extent of the disclosure obligation for companies proposing to issue classes of disparate voting rights stock. Implicit in the Commission's request for comment on this matter was the suggestion that the requirement of full disclosure to shareholders of the potential adverse impact of dual voting recapitalization on the market value of the recapitalized securities might discourage a significant number of disparate voting recapitalizations.

122. Section 19(b) provides that the "Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this chapter." 15 U.S.C. § 78s(b)(2) (1982).

123. Exchange Act Release No. 23,724, *supra* note 121.

124. Exchange Act Release No. 23,803, *supra* note 120, at 41,715.

125. *Id.* at 41,716-18. In addition, other commentators have raised questions about the authority of the SEC to regulate shareholder voting rights through its review of exchange listing requirements. *SEC Seeks Views on Possible Compromise on 1-Share, 1-Vote Rule for Stock Markets*, Wall St. J., Dec. 18, 1986, at 5, col. 1; see also an article by former Commissioner Roberta Karmel in 36 Cath. L. Rev. \_\_\_\_ (1987) (not published at the time this article went to press).

Hearings were held on the NYSE proposal on December 16 and 17. Opposition by industry representatives, institutional investors, academicians, and leaders of shareholder rights groups was close to uniform. Even NYSE chairman Phelan indicated that he would prefer not to change the listing rules but felt compelled to do so to preserve the NYSE's competitive position.<sup>126</sup> Based upon the Commission's recent willingness to allow market forces to dictate its securities market regulatory policy, it is not unreasonable to speculate that the Commission's response to the one share, one vote question might have been to allow the trading markets to impose whatever listing standards they find acceptable and to rely upon a rigorous disclosure policy imposed upon issuers to ensure that those listing standards meet the needs of the investing public. But in light of the strong public sentiment against lessening the one share, one vote standard, it is now quite possible that the Commission will disapprove the NYSE proposal and seek to impose elevated standards on other trading markets.<sup>127</sup>

### *RULE 10b-6 AND RESALES BY SHELF-SHAREHOLDERS*

In late summer 1986, the Commission promulgated a new interpretation (the "New Interpretation Release")<sup>128</sup> regarding the application of rule 10b-6<sup>129</sup> to participants in shelf-registrations. Rule 10b-6 prohibits persons engaged in a distribution from purchasing or bidding for securities they are distributing until they have completed their participation in the distribution. The rule is designed to prevent participants in a distribution from facilitating the distribution by artificially supporting the price of securities being sold. When the Commission defined the term "distribution"<sup>130</sup> in rule 10b-6, it specifically noted that shelf-registered offerings<sup>131</sup> were to be included within the definition.

The inclusion of shelf-registered offerings within the restrictions of rule 10b-6 meant that even in the instance of shelf-offerings involving the resale of restricted securities by numerous shareholders, participants in the distribution (including each shelf-shareholder) would have to coordinate their market activities with one another and with the issuer.<sup>132</sup> No shelf-shareholder could pur-

126. *Stockholders Voting Rights Defended*, Wash. Post, Dec. 17, 1986, at C1, col. 3.

127. See *SEC Seeks Views*, *supra* note 125, at 5, col. 1.

128. Exchange Act Release No. 23,611, 3 Fed. Sec. L. Rep. (CCH) ¶ 22,767 (Sept. 11, 1986).

129. 17 C.F.R. § 240.10b-6 (1986).

130. A distribution "is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." *Id.* § 240.10b-6(c)(5).

131. Shelf-registered offerings are distributions of securities sold on a delayed or continuous basis. Although shelf-registered offerings had been permitted by administrative practices prior to 1983, it was not until that year that the Commission adopted rule 415, which permits shelf registration for a variety of classes of securities.

132. Exchange Act Release No. 19,565, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,328 (Mar. 4, 1983).

chase securities during a distribution by any other shelf-shareholder during the rule 10b-6 cooling-off period<sup>133</sup> prior to the distribution.

In promulgating a new interpretation regarding the impact of rule 10b-6 on shelf-registrations, the Commission noted that the Staff had recently been confronted with distributions that individually involved a large number of shelf-shareholders.<sup>134</sup> The historical interpretation of rule 10b-6 required "an unwieldy coordination effort among the [s]helf-[s]hareholders" jeopardizing the shelf-registration itself.<sup>135</sup> Since, in many situations, the majority of the shelf-shareholders are unaffiliated with the issuer, compelling coordination among the shelf-shareholders lacked a certain amount of logic. It would be unlikely that the purchasing efforts by one unaffiliated shelf-shareholder would be designed to condition the market for another unaffiliated shelf-shareholder who was selling his portion of the distribution.

To remedy this anomaly, the Commission advised that individual shelf-shareholders, unaffiliated with the issuer or other shelf-shareholders, will now be required to observe the rule 10b-6 restrictions only with respect to their own offers and sales off the shelf.<sup>136</sup> Shelf-shareholders affiliated with the issuer will continue to be required to coordinate purchasing and selling activities with the issuer, and shelf-shareholders affiliated with other shelf-shareholders will continue to be required to coordinate market activity with their affiliated shelf-shareholders.<sup>137</sup> In addition, shelf-shareholders who sell all of their securities registered on the shelf or who withdraw from such registration will no longer be covered by the rule 10b-6 prohibitions if they are not affiliated with either the issuer or with any shelf-shareholder who continues to have shares on the shelf.

A second issue that the Commission explored in promulgating its new interpretation of rule 10b-6 was whether a broker-dealer who sells securities on behalf of a shelf-shareholder is participating in the distribution of securities and, consequently, obligated under the rule to refrain from bidding for or purchasing the securities during the distribution and cooling-off periods. Historically, in *Jaffee & Co.*,<sup>138</sup> the Commission had held that a market maker that resold stock known to be part of a registered shelf-offering was participating in the registration. The *Jaffee* holding, however, was based upon the Commission's position that a registered offering, by its very nature, constituted a distribution for purposes of rule 10b-6.<sup>139</sup> The Commission later overruled that interpretation in *Collins Securities Corp.*<sup>140</sup> The Commission advised in its New Interpre-

133. Rule 10b-6(a)(3)(xi) prohibits specified parties from bidding for or purchasing securities subject to a distribution both during the distribution and during a cooling-off period of either two or nine days' length (depending upon the nature of the security) prior to the distribution.

134. New Interpretation Release, *supra* note 128.

135. *Id.* at 16,631-15.

136. *Id.*

137. *Id.*

138. 44 S.E.C. 285 (1970), *aff'd in part and vacated in part*, 446 F.2d 387 (2d Cir. 1971).

139. 44 S.E.C. at 288.

140. 46 S.E.C. 20 (1975), *rev'd and remanded on other grounds*, 562 F.2d 820 (D.C. Cir. 1977).

tation Release that the new definition of distribution in rule 10b-6(c)(5)<sup>141</sup> is now controlling. Consequently, a broker-dealer that resells a shelf-shareholder's securities will be found to be involved in a distribution only if the amount of securities it is selling is of sufficient magnitude and its selling efforts are sufficiently active to constitute a distribution. The Commission also advised that "as a general proposition, the disposition of [shares sold for a shelf-shareholder or bought from a shelf-shareholder] in 'normal trading transactions' into an independent market [a market absent of domination, control, or manipulation by the broker-dealer or those acting in concert with the broker-dealer] will not subject the broker-dealer to the restrictions of Rule 10b-6."<sup>142</sup>

Perhaps the next time rule 10b-6 undergoes major modifications, the Commission's new interpretations will find their way into the specific language of the rule. Until then, practitioners in this area will have to remain sensitive to the Commission's New Interpretation Release.

### *MODIFICATION OF EXCHANGE RULES DISCOURAGING INTEGRATED RETAIL BROKERAGE FIRMS FROM OPERATING SPECIALIST UNITS*

A chronic securities industry problem for which remedial regulatory action was undertaken this past year is the inadequate capitalization of specialist units on the New York and American Stock Exchanges. With the increasing institutionalization of the securities market and the shift of more institutions to a practice of active portfolio trading, both the total volume and average size of trades on the primary markets have significantly increased. In addition, the primary markets have experienced frequent imbalances in buying and selling pressures as a result of increasingly popular hedging and arbitrage strategies employing stock, stock options, stock-index futures, and stock-index options. Against the markets' gyrations, specialist units on the New York and American Stock Exchanges continue to apply their entrepreneurial capital in order to fulfill their commitment to maintain "fair and orderly markets."<sup>143</sup>

For some time, it has been apparent that for specialists to continue to be effective in their roles, an infusion of greater capital is necessary. More capital would allow specialists to offset the larger market imbalances brought about by the increasingly institutionalized nature of the market and the growth of arbitrage and hedging strategies involving securities and derivative stock products. One obvious source of capital could become available if the large integrated retail brokerage firms began operating specialist units.

141. New Interpretation Release, *supra* note 128, at 16,631-21 to -22. See *supra* note 130.

142. New Interpretation Release, *supra* note 128, at 16,631-22 (footnote omitted).

143. Rule 11b-1 permits exchanges to register specialists so long as, among other matters, exchange rules require the specialist "to engage in a course of dealings for his own account to assist in the maintenance . . . of a fair and orderly market." 17 C.F.R. § 240.11b-1(a)(2)(ii) (1986).

Until recently,<sup>144</sup> New York and American Stock Exchange rules, while not prohibiting the operation of specialist units by retail brokerage firms, strongly discouraged these operations. The rules did this by prohibiting persons affiliated with specialist units from, among other matters: (i) trading the securities traded by the affiliated specialist; (ii) trading options on such specialty securities; (iii) accepting orders in such specialty securities from institutions, the issuer, or insiders of the issuer; or (iv) providing research or advisory services with regard to such specialty securities.<sup>145</sup> These exchange rules, with their intended deterrent effect on the entry of retail brokerage firms into the specialist business,<sup>146</sup> have been defended as desirable in light of the informational and trading advantage that an affiliated specialist firm would otherwise possess as a result of a relationship with a large integrated retail brokerage firm.

In proposing rule modifications to remove prohibitions on brokerage firms affiliated with specialist units, the two primary exchanges also sought to provide a mechanism to eliminate the advantages that an affiliated specialist unit would have over a specialist unit not affiliated with a brokerage firm. The modification to the New York and American Stock Exchange rules that the Commission approved in November 1986<sup>147</sup> provides an exemption from the prohibitions mentioned above if the brokerage firm establishes and the respective exchange approves an organizational separation, or Chinese Wall, between the brokerage firm and the affiliated specialist unit.

In order to obtain exemptive relief, the brokerage firm would be required to get prior written approval from the exchange indicating that the firm had complied with the exchange's guidelines for establishing the Chinese Wall. In addition, the firm would have to demonstrate that it had established appropriate compliance and audit procedures to maintain the wall's integrity. The exchange must itself monitor the Chinese Wall procedures established by the firm and the proprietary trades by the affiliated specialist unit and the brokerage firm.<sup>148</sup>

While the Chinese Wall might significantly reduce or eliminate the transmission of market sensitive information between the affiliated brokerage firm and its specialist unit and vice versa, it does not confront the potential for trading advantages that might arise as a result of a specialist/brokerage firm affiliation. Nothing in the modified rule will prevent large retail firms from establishing a regular practice of routing their order flow to their affiliated specialist units.

In response to this conflict, the Commission has routinely reminded brokerage firms of their "continuing obligations to provide their customers with best

144. On November 3, 1986, the Commission approved New York and American Stock Exchange rule proposals modifying their prohibitions on the activities of brokerage firms affiliated with specialist units. Exchange Act Release No. 23,768, 51 Fed. Reg. 41,183 (1986).

145. *Id.* at 41,183-84.

146. Only two retail brokerage firms on the NYSE and Amex are affiliated with specialist units. *Id.* at 41,183 n.3.

147. *Id.* at 41,190.

148. *Id.* at 41,184.

execution of their orders.”<sup>149</sup> As has historically been the case,<sup>150</sup> the Commission refrained from imposing a specific best execution obligation on such affiliated brokerage firms vis-a-vis their specialist traded securities. The Commission did, however, remind the industry that the affiliated specialist firm would have to “hand off the book” for the appropriate period specified under rule 10b-6 whenever the affiliated brokerage firm participated in an underwriting of a security traded by the specialist.<sup>151</sup>

### TRIPLE-WITCHING FRIDAY EXPERIMENT

In response to a request by the SEC, the NYSE took a tentative step to remedy the uncertain effects of the concurrent expiration on four Fridays a year of contracts on stock options, stock-index options, and stock-index futures. These days have been designated as “triple-witching Fridays.” It is believed that this concurrent expiration has fueled sharp market gyrations in the securities that underly these options and futures because investors tend to close out sophisticated hedging and arbitrage positions in the underlying securities and the derivative securities products in the period of time immediately prior to the common expiration. These unwinding efforts result in market imbalances and consequent steep market price swings in the underlying securities involved in the trading strategies.

On September 11, 1986, the Commission sent a letter to the NYSE “suggesting” that the exchange ask its member firms to submit all market-on-close orders in thirty heavily traded securities one-half hour prior to market close at the next quarterly common expiration date (September 19, 1986).<sup>152</sup> The rationale behind the Commission’s request was that during the last half-hour of trading, the exchange would announce any market imbalances in the subject securities and investors would have an opportunity to respond to securities considered either overpriced or underpriced. The Commission hoped that this investor reaction would help to correct projected imbalances.

Although the September 19th closing did not witness extraordinary price gyrations, regulators were unwilling to credit the results to the early reporting of imbalances.<sup>153</sup> The Commission determined to continued the experiment for the final triple-witching Friday of the year, December 19. It requested that, one-half hour prior to closing, the NYSE disseminate market-on-close trading imbalances in fifty heavily traded securities that underly stock index options and futures. Despite record activity, the volatile price swings of the past did not occur. Some observers attributed this to the disclosures requested by the SEC,

149. *Id.* at 41,189.

150. See Lipton, *Best Execution: The National Market System’s Missing Ingredient*, 57 Notre Dame Law. 449 (1982).

151. Exchange Act Release No. 23,768, *supra* note 144, at 41,188.

152. *SEC Asks Big Board to Test Proposal Aimed at Curbing Sharp Price Swings*, Wall St. J., Sept. 11, 1986, at 45, col. 1.

153. “Triple Witching” Didn’t Bewitch Market, Regulators Aren’t Sure Who Gets Credit, Wall St. J., Sept. 22, 1986, at 42, col. 3.



but others remained skeptical.<sup>154</sup> In any case, the industry will probably continue to experiment with methods to counter the trading gyrations surrounding the termination of the derivative stock product contracts.

## STOCK TRANSFER AGENT REGULATIONS

The SEC amended regulations governing transfer agents in three 1986 releases. In February, the SEC amended the Exchange Act's rules to require transfer agents to respond promptly to written inquiries regarding dividend and interest payments.<sup>155</sup> The response must be in writing and must indicate when the claim was received, whether the claim requires further research, and, if so, how long the research may take. Where no more research is needed, the response must indicate whether a claim will be paid or not. If it will not be paid, then the response must explain why.

In the same release, the SEC expanded the period for transfer agents to repurchase overissued securities.<sup>156</sup> Amended rule 17Ad-10(g)(1) gives transfer agents sixty days from the "discovery of [an] overissuance," instead of thirty, to recover overissued securities before a "buy-in" is required. The SEC also amended the rule to exempt from the buy-in requirement actual overissuances covered by open penalty surety bonds. Such an overissuance usually occurs as a result of replacement of a lost or stolen certificate.

The SEC later amended its forms and rules for transfer agent registration and monitoring. In addition, a new annual report, form TA-2, was adopted corresponding to rules requiring transfer agents to report the nature and scope of their business activities to the SEC on an annual basis.<sup>157</sup>

Finally, the SEC altered the definition of "item" in rule 17Ad-1 as it relates to transfer instructions to mean each separate line on a depository shipment control list. This facilitates transfer agents' meeting the requirement under this rule to turn around ninety percent of the routine "items" they receive for transfer within three business days.<sup>158</sup>

154. *Regulators Brace for Wild Stock Swing*, Wall St. J., Dec. 5, 1986, at 6, col. 1. On December 19, 1986, almost 244.7 million shares traded on the NYSE, orders for an unprecedented 85 million shares being executed in the last minute. *Wall St.'s Memorable Minute*, N.Y. Times, Dec. 20, 1986, at 35, col. 3.

155. Exchange Act Release No. 22,882, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,964 (Feb. 10, 1986) (amending rule 17Ad-5, effective Apr. 1, 1986).

156. *Id.* (amending rule 17Ad-10, effective Apr. 1, 1986).

157. Exchange Act Release No. 23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,975 (Apr. 1, 1986) (revising form TA-1, adding form TA-2, and amending rule 17Ac2, effective May 9, 1986).

158. Exchange Act Release No. 23,677, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,033 (Oct. 2, 1986). The definition of item with respect to transfer instructions that are not on depository shipment control lists has remained unchanged. The changes were in response to concerns expressed by transfer agents and depository participants concerning the SEC's prior interpretation of item, which treated each of the transfer instructions on a depository shipping control list as a single routine item. Transfer agents were concerned that the SEC's previous interpretation did not recognize that the average number of lines on certain lists had doubled in

## ACCOUNTING REGULATORY DEVELOPMENTS

### NEW PENSION ACCOUNTING STANDARDS: FASB STATEMENTS NOS. 87 AND 88

In December 1985, the Financial Accounting Standards Board ("FASB") issued Statement No. 87, *Employers' Accounting for Pensions*, which will require a standardized method for measuring pension cost and reflecting liabilities for pension obligations, and Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, which will enable an employer to recognize gain when entering into an asset reversion transaction involving the termination of one plan and the establishment of a successor defined benefit plan.

The FASB theory about pensions is that an employer with an unfunded pension obligation has a liability and an employer with an over-funded pension obligation has an asset. To reflect this, FASB Statement No. 87 requires immediate recognition of a liability when the "accumulated benefit obligation" exceeds the fair value of assets in the pension plan. This provision will cause some corporations to recognize greater liabilities than those required under current generally accepted accounting principles and, as a result, will have an adverse effect on debt-to-equity ratios.

FASB Statement No. 88 requires immediate recognition of certain previously unrecognized amounts when specified transactions or events occur, and it prescribes the method for determining the amount to be recognized in earnings when a pension obligation is settled or a plan is curtailed.

FASB Statements Nos. 87 and 88 are effective for fiscal years that begin after December 15, 1986 with certain exceptions. The presentation of an unfunded "accumulated benefit obligation" as required by FASB Statement No. 87 is effective for fiscal years beginning after December 15, 1988.

### ANTI-GREENMAIL ACCOUNTING: FASB TECHNICAL BULLETIN NO. 85-6

On December 31, 1985, FASB issued Technical Bulletin No. 85-6<sup>159</sup> pertaining to accounting for the effect of a target company's reacquisition of shares in a "greenmail" transaction. The technical bulletin requires a target corporation purchasing its own stock from a corporate raider at a price significantly exceeding the current market price of those shares to expense the excess. This treatment will result in a charge to current operations of the corporation purchasing its own stock, which will reduce net income, earnings per share, retained earnings, and shareholders' equity.

recent years. Hence, transfer agents could find it harder to meet their 90% turnaround requirement under rule 17Ad-2.

159. Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt, Technical Bulletin No. 85-6 (FASB 1985).

The technical bulletin further states that neither costs incurred by a company to defend against a takeover attempt nor costs attributable to a standstill agreement should be classified as extraordinary charges. The technical bulletin is effective for all transactions after December 31, 1985.

### *DISCLOSURE REQUIREMENTS REGARDING REPURCHASE AND REVERSE REPURCHASE AGREEMENTS*

On January 22, 1986, the SEC issued Financial Reporting Release No. 24, which amended the disclosure requirements of regulation S-X to require the disclosure in certain cases of the nature and extent of filing companies' repurchase and reverse repurchase agreements, as well as the degree of risk involved in these transactions.<sup>160</sup>

The amendments require that where the higher of the carrying amount or the market value of assets sold under repurchase agreements or the carrying value of reverse repurchase agreements exceeds ten percent of total assets, the amounts involved should be disclosed as a separate line in the balance sheet. In addition, footnote disclosure may be required regarding assets sold, the terms of the agreements, the company's policies concerning the taking of possession of the underlying assets, the provisions to ensure that the market value of the underlying assets remains sufficient to protect the company in the event the counter party defaults, and the identity of the counter party.

### *SEC CONSOLIDATION POLICY CHANGES*

On May 6, 1986, the SEC revised rule 3A-02 of regulation S-X regarding the use of consolidated financial statements for a company and its subsidiaries.<sup>161</sup> In an attempt to allow the substance of a particular relationship, rather than its form, to dictate whether financial statements should be consolidated, the SEC eliminated from rule 3A-02 the words that suggested an absolute prohibition against consolidating "any subsidiary which is not majority owned."<sup>162</sup> The amendment makes it clear that a company and its accountant must evaluate the facts and circumstances to determine whether an entity is a controlled subsidiary and must adopt a consolidation policy that clearly exhibits the financial position and results of operations of a company and its subsidiaries. These changes do not affect current accounting practices of companies that do not consolidate finance and other nonhomogeneous subsidiaries.

160. Securities Act Release No. 6621, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,424 (Jan. 22, 1986).

161. Securities Act Release No. 6641, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,425 (May 6, 1986).

162. *Id.* at 62,109.

## *SEC VIEWS ON REPORTING FOR REDEEMABLE PREFERRED STOCK AND CHEAP STOCK*

On October 2, 1986, the Staff issued an accounting bulletin ("SAB-64")<sup>163</sup> relating to accounting for redeemable preferred stock, the issuance of shares prior to a public offering, and reporting of income or loss applicable to common stock.

The Staff noted in SAB-64 that redeemable preferred stocks are not included in amounts reported as stockholders' equity and that their redemption amounts are to be shown on the face of the balance sheet. The Staff felt that the carrying amount of redeemable preferred stock should be its fair value at the date of issue. However, where fair value on the date of issue is less than the mandatory redemption amount, the carrying amount must be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amounts must be further increased periodically by amounts representing dividends payable under the mandatory redemption features. Each type of increase in carrying amount must be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. This method of accounting applies irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date or whether it may be converted into another class of securities by the holder.

The Staff also addressed the issue of computing earnings per share where a company has issued common stock below the initial public offering price ("cheap stock" or "cheap warrants"). SAB-64 provides that cheap stock and warrants should be treated as outstanding for the entirety of all reported periods in a registration statement prepared in connection with an initial public offering, in the same manner as are shares issued in a stock split or recapitalization effective contemporaneously with an initial public offering. The Staff noted the departure from the computational guidelines of Accounting Principles Board ("APB") Opinion No. 15<sup>164</sup> (which requires the use of weighted average shares outstanding) and argued that it was necessary because of the relatively small consideration typically received for cheap stock and cheap warrants. However, the registrant can avoid such treatment if the instruments were issued at fair value and were not issued in contemplation of a public offering.

## *EFFECTS OF 1986 TAX REFORM ACT ON TAX DEFERRED LIABILITIES AND ACCOMPANYING DISCLOSURE*

On October 23, 1986, the SEC, in an interpretive release, stated that publicly held companies will be able to present supplemental financial information in their financial statements quantifying the effects of the 1986 Tax Reform Act on

163. Staff Accounting Bulletin No. 64, 6 Fed. Sec. L. Rep. (CCH) ¶ 74,064 (Oct. 2, 1986).

164. Earnings Per Share, APB Opinion No. 15 (1969).

deferred tax liabilities.<sup>165</sup> The Tax Reform Act's lowering of the tax rates for many companies will cause future payments of deferred taxes to be at rates sharply lower than those used to determine deferred income tax provisions under APB Opinion No. 11 ("APB 11").<sup>166</sup> APB 11 requires that deferred taxes be determined at the tax rate in effect in the current year; they may not be adjusted for subsequent tax rate changes. As a result, a company's existing deferred tax balances, which are generally based on statutory tax rates ranging from forty-six to fifty-two percent, will not be reduced to reflect the fact that those deferred taxes will be paid at substantially lower rates.

FASB has proposed a statement that, if approved as proposed, would supersede APB 11 and require a liability approach to be used when accounting for deferred taxes.<sup>167</sup> The liability method would require companies to reflect deferred taxes based on enacted rates that would apply during the period the taxes become payable. In addition, the proposal would require companies to reflect tax provisions on undistributed earnings of foreign subsidiaries that would have a potentially significant impact on U.S. multinational companies. Until the proposed statement becomes effective, the SEC will give companies the option of providing quantified supplemental information that presents their 1986 financial position as if the FASB proposal were in effect. Even if companies do not quantify the effects of the Tax Reform Act, a narrative discussion of the act's effects on results of operations and sources and uses of capital resources in future periods must be provided in the Management's Discussion and Analysis section of the annual report.

On October 28, 1986, FASB issued Technical Bulletin No. 86-1, *Accounting for Certain Effects of the Tax Reform Act of 1986*, which requires that companies report the aggregate effects of retroactive provisions of the Tax Reform Act as a component of income tax expense in the period that includes the act's October 22, 1986 enactment date. The effects on income tax expense should be disclosed.

## *TIGHTENING OPINION SHOPPING RULES*

The American Institute of Certified Public Accountants' Auditing Standards Board has issued guidelines ("SAS No. 50") to independent certified public accountants who may be approached by a client of another firm for an interpretation of a generally accepted accounting principle.<sup>168</sup> The guidelines apply to written reports on the application of accounting principles and to oral advice that is to be used as an important factor in reaching a decision.

SAS No. 50 requires accountants who issue these reports or give such oral advice: (i) to consult with the inquirer's current accountant to ascertain that all

165. Securities Act Release No. 6671, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,426 (Oct. 23, 1986).

166. Accounting for Income Taxes, APB Opinion No. 11 (1967).

167. Accounting for Income Taxes, Proposed Statement of Financial Accounting Standards (FASB 1986).

168. Statement on Auditing Standards No. 50, *Reports on the Application of Accounting Principles*, 162 J. Accountancy 192 (1986).

available facts relevant to forming an opinion are known; (ii) to obtain an understanding of the form and substance of the transactions; (iii) to review applicable generally accepted accounting standards; (iv) to consult with other professionals or experts, if appropriate; and (v) to perform research or other procedures to determine whether creditable precedents or analogies exist, if appropriate. SAS No. 50 also establishes guidelines for the contents of such written reports.

### *ACQUISITION ACCOUNTED FOR AS A POOLING OF INTERESTS*

The Staff issued an accounting bulletin on November 5, 1986 ("SAB-65"),<sup>169</sup> which provides that in a business combination accounted for as a pooling of interests, affiliates of *both* the acquirer and the target are subject to restrictions on share dispositions. These restrictions apply to sales both before and after the consummation of the transaction. The Staff will generally not raise a question about the applicability of pooling of interests accounting as a result of dispositions of shares by affiliates thirty days before the consummation of a business combination.

### *FASB CASH FLOW STATEMENT PROPOSAL*

On July 31, 1986, FASB issued a proposed statement that would require companies to present a statement of cash flows as part of a full set of financial statements.<sup>170</sup> The proposed cash flow statement would replace the statement of changes in financial position. The cash flow statement would classify cash receipts and cash payments by investing, financing, and operating activities. If adopted as a final statement, it would be effective for financial statements for fiscal periods ending after June 30, 1987.

### *INFLATION ACCOUNTING*

FASB Statement No. 33, relating to *Financial Reporting and Changing Prices*, was replaced by FASB Statement No. 89, effective December 2, 1986. As a result, companies issuing financial statements after December 2, 1986 will no longer be required to provide supplemental disclosures as to the impact of inflation on their operations. The effect of the new statement is to make changing price disclosures voluntary and to encourage companies to experiment with different methods of providing changing price disclosures. This action reflects the declining impact of inflation.

169. Staff Accounting Bulletin No. 65, 6 Fed. Sec. L. Rep. (CCH) ¶ 74,065 (Nov. 5, 1986).

170. Statement of Cash Flows, Proposed Statement of Financial Accounting Standards (FASB 1985).

To conform its regulations with the FASB action, the SEC issued a release interpreting item 302 of regulation S-K.<sup>171</sup> Item 302 formerly required registrants subject to FASB Statement No. 33 to disclose supplementary financial information on the impact of inflation. The SEC's new release relieves these registrants from the obligation to furnish this data but encourages them voluntarily to quantify the effects of inflation and changes in prices in their financial statements.

It should be noted that, although specific numerical information is not required, item 303(a)(3)(iv) of regulation S-K continues to require registrants to include a narrative discussion of the impact of inflation in the Management's Discussion and Analysis of Financial Condition and Results of Operations in the annual report on SEC form 10-K.

### *PROCEDURES FOR ACCOUNTING FOR LOAN LOSSES*

On December 1, 1986, the SEC, in an interpretive release, expressed its views regarding the reporting of loan losses by registrants engaged in lending activities.<sup>172</sup> The Staff recognized that certain registrants lack adequate documentation of procedures for reviewing and identifying risks inherent in loan portfolios and for assessing the overall quality of their portfolios. The Staff stated that registrants engaged in lending activities should have documentation of a systematic methodology that is employed in determining the amount of loan losses to be reported and a rationale supporting the determination that the amounts reported were adequate.

The Staff also addressed the requirement to account for loan collateral as repossessed whether the repossession is formal or substantive in compliance with the fair value accounting required by FASB Statement No. 15.<sup>173</sup> Collateral should be considered repossessed and accounted for at its fair value when a collateralized loan, because of the surrounding facts, represents a loss contingency for the creditor and is being evaluated for possible accrual of the loss contingency, irrespective of whether the loan has been formally restructured. The Staff provided certain criteria to be applied in determining whether collateral has been substantively repossessed and guidelines for the valuation of collateral that is formally or substantively repossessed.

### *THE PROGRESS AND PROBLEMS OF EDGAR*

The SEC's electronic data gathering, analysis, and retrieval project ("EDGAR") is currently accepting filings from approximately 230 volunteer compa-

171. Securities Act Release No. 6681, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,050 (Dec. 18, 1986).

172. Securities Act Release No. 6679, 6 Fed. Sec. L. Rep. (CCH) ¶¶ 72,428, 73,520 (Dec. 1, 1986).

173. Accounting by Debtors and Creditors for Troubled Debt Restructuring, Statement of Financial Accounting Standards No. 15 (FASB 1977).

nies. The number of volunteers in the pilot project is being restricted to its current level. Although test filings by other registrants are encouraged and the SEC has announced that registrants will be phased into the system in small groups beginning in 1987, there appear to be some problems in implementing this timetable. Typical filings currently being accepted by EDGAR include 10-Ks, 10-Qs, 8-Ks, and registration statements under the Exchange Act and the Securities Act, as well as filings from investment companies and public utility holding companies. During 1986, the SEC also provided that participants in the pilot project may submit filings under the Williams Act electronically.<sup>174</sup>

Documents are filed in one of three ways: direct transmission over phone lines, delivery of magnetic tape, or delivery of a diskette. Direct transmission filings may be made between the hours of 7:30 a.m. and 7:00 p.m. eastern time. The SEC is currently accepting diskette filings prepared from over eighty-five different types of word processors and personal computers. In addition, electronic mail capabilities exist for transmitting comment letters and other correspondence between filers and the SEC.

The SEC recently issued a proposed rulemaking for the operational stage of the EDGAR system.<sup>175</sup> The proposal envisions implementing EDGAR over a three-year, phase-in period, making only those changes to the pilot program rules that would be necessary for mandatory electronic filing by all registrants. Among other things, the proposed rules would provide a hardship exemption from electronic filing in limited circumstances, permit the paper filing of graphic and image material that cannot feasibly be transmitted electronically utilizing current technology, and require the submission in electronic format of all material incorporated by reference. The latter requirement, if adopted, is likely to be very unpopular among registrants because of the time and expense involved in electronically formatting large documents, such as annual reports, that are frequently incorporated by reference.

In addition, the proposed rulemaking requested comments with respect to the signature process for direct transmission filings. Under the pilot project, direct transmission filings are signed by means of personal identification numbers ("PINs"). A PIN is a unique series of characters assigned by the SEC to a natural person or entity that is entered on the signature line of the filing in lieu of a manual signature. During the pilot project, some participants expressed concerns about administrative problems and security related to PINs. For example, when signers are geographically distant from the place of transmission, there may be the same difficulties in delivering the PINs as would exist in today's manual filing system. Security concerns have been expressed because once the PIN is typed on the filing, it is visible to anyone who has access to the filing before transmission. A possible solution to this problem is to use typed signatures in the electronic filing with a representation by the registrant in the

174. Securities Act Release No. 6634, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,976 (Mar. 28, 1986).

175. Securities Act Release No. 6681, Exchange Act Release No. 23,374, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,010 (June 26, 1986).



filing that a manually signed copy is contained in its files that will be made available to the SEC and others upon request.

The SEC recently encountered its most significant obstacle yet to fully implementing EDGAR. In attempting to obtain a contractor to install and maintain the computer system necessary for operational EDGAR, the SEC apparently failed to provide sufficient economic incentive for any contractor to undertake the project. As a result, the SEC received no bids for the contract. House Energy and Commerce Committee chairman John Dingell has sharply criticized the EDGAR system for being behind schedule and over budget.<sup>176</sup> In addition, the General Accounting Office recently urged the SEC to delay awarding a contract for operational EDGAR until it obtains better estimates of costs and quantitative benefits from EDGAR, as well as an adequate description of qualitative benefits.<sup>177</sup> In spite of these problems, the Staff has informally stated that extension of this program to nonvolunteers is expected toward the end of this year.

The SEC extended until January 30, 1987 the deadline for submitting bids on a revised EDGAR contract.<sup>178</sup> The pilot project will continue until a contract is awarded and the three-year, phase-in period for operational EDGAR begins. The SEC announced that it would propose a fiscal 1988 budget that contains the agency's largest budget increase in several years. A large part of the proposed increase would be used to get EDGAR ready for operation.<sup>179</sup>

The SEC believes that the EDGAR system, once fully operational, will provide several improvements over the manual filing system. Electronic filings will provide investors with instant access to a broad range of information with which to make more informed decisions. Easy access to such information could also improve the market for less widely traded securities. Operational EDGAR should also lead to efficiencies in filing documents with the SEC and in the review of such filings by the Staff.

176. Lyons, *EDGAR Lays an Egg*, Legal Times, Sept. 15, 1986, at 1, col. 1.

177. Ingersoll, *EDGAR, The SEC's Planned Data System, Remains in High-Tech Limbo as New Bid Deadline Nears*, Wall St. J., Nov. 28, 1986, at 36, col. 1. Also, due to the delays within the federal electronic filing system, an NASD staff committee has recommended that the state securities administrators create a prototype centralized securities filing system as part of the Central Registration Depository System to serve as a temporary alternative to EDGAR. [July-Dec.] Sec. Reg. & L. Rep. (BNA) No. 18, at 1618 (Nov. 7, 1986).

178. *SEC Extends Due Date for EDGAR Bid*, SEC Today, Dec. 4, 1986, at 1.

179. Ingersoll & Swartz, *Shad is Seeking Biggest SEC Budget Rise in 50 Years to Bolster Enforcement Effort*, Wall St. J., Dec. 8, 1986, at 5, col. 1.